Central Banking in a Planned Economy

The Indian Experiment

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The Indian Experiment

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TATA McGRAW-HILL PUBLISHING CO. LTD.
NEW DELHI

Published by
Tata McGraw-Hill Publishing Company Limited,
12/4 Asaf Ali Road, New Delhi 110002,
and printed at Prem Printing Press,
257 Golaganj, Lucknow 226001

Dedicated
To
Professor Richard H. Timberlake, Jr.,
University of Georgia (USA),

Who helped Me at Different Stages
of this Study

Foreword

The Reserve Bank of India has completed forty years of its existence. According to central banking standards this is a comparatively young age. Though not an old institution, the Indian central bank has gathered, in its short life, a rich variety of experience in the regulation and control of a loose and unorganized money market as also in the task of promoting the development of the underdeveloped Indian economy. The Bank was set up on the model of the Bank of England, much against the views of the late Lord Keynes, who submitted in his memorandum to the Royal Commission on Indian Currency and Finance that the model for a central bank for India was to be sought, not in the Bank of England, but in some other country of Europe. The Indian opposition to the proposal for a central bank was not on Keynesian grounds, but on the question whether it was to be set up as a private shareholders' bank or a state-owned bank. Keynes was, of course, in favour of a state-owned bank. Many things had happened since 1935 when the Reserve Bank opened its doors. Nationalization followed in 1948 immediately after its godfather, the Bank of England, got the same treatment. From the next year the Reserve Bank was granted a large number of controls over the banks, and the field of controls became wider and clearer in subsequent years. These powers of regulation were applied rather hesitantly at the beginning—a quite natural phenomenon. But as the initial period of experimentation was over, the Bank's grip over the banking system increased with salutary effects. The banking system became purged of its unsavoury elements and in the process became stronger and well-knit, a factor which helped its nationalization in later times without many ripples on the surface. The Reserve Bank's handling of the Banking Regulation Act of 1949 paved the way for the take-over of banking in 1969. The second impact was on the Reserve Bank itself. As the foundations of the banking structure became stronger as a result of the regulatory activities of the Reserve Bank, the need for changing that structure to suit Indian conditions came to be increasingly felt. The regulating central bank had then to devote its attention and activities to the next task of helping the banking system to concern itself more and more with the realities of the Indian economy. That has no doubt meant significant changes in the functioning of the Reserve Bank, and it is to the credit of those who were in charge of its affairs during these crucial years that they did not hesitate to pursue this important role, which was in many respects different from the pattern of traditional central banking. Of course, one may

always raise this question, is there or was there, really any, traditional system of central banking? The Bank of England functioned in the way or ways it did or is doing because it had to operate against the background of the London money market. With just a few similarities, the Bank of France operated in a number of different ways as it had to work in the French money market. The Federal Reserve system in the USA provided in a number of important points quite a different model with a different set of control instruments as the conditions in the developing money markets of that country were different. The great merit of the Reserve Bank is that it had during these forty years been making an honest attempt to get away from its Scotch and Bank of England legacies to become a full-fledged Indian central bank, as Indian as the Ganges. One can easily understand that the process of change had not been an easy one, as all of us, including those in charge of the Bank, had been brought up on what might be called the classical central banking principles. The Reserve Bank of India had no doubt departed materially from the ideas and ideals of its founders. It is doubtful whether Sir Basil Blackett, the Finance Minister who introduced the first Reserve Bank of India Bill in the then Indian Legislative Assembly, would now be able to recognize his dreamchild in the full-grown young Reserve Bank of today.

Flux universal. All things change and the Reserve Bank has also undergone many changes. What the theoretician can and should do is to examine those changes and assess their utility in the light of the needs of the economy. Dr Basu has made a very good attempt to do that in this outstanding book. He has sought to write a balanced, careful and objective review of the working of the Reserve Bank *vis-a-vis* the banking system of India. Starting with the traditional concept of the central bank as the regulatory agent, he has ably traced the evolution and change in the functioning of the Indian central bank as it pursued its promotional and developmental activities. According to him, the Reserve Bank is no longer just a controller of funds, but has emerged as what he has termed "innovator of economic and social change." His statement is likely to give rise to a number of important questions, and he has attempted to provide suitable answers to many of them. Specially valuable has been his discussion of the relationship of the government with the Reserve Bank, and in this connection he has collected a lot of rare material on this subject from the examples of central banks in other countries. This is likely to prove highly interesting to students of monetary theory. Dr Basu's elaborate treatment of the relation of the Reserve Bank with the development banks and institutions, and the demarcation he has sought to make between the spheres of development banking, commercial banking and central banking will be profitably studied by all those who are interested in the subject.

I am sure that monetary theorists will welcome this excellent study which provides a good background with a great deal of material for the assessment of this central bank. This monumental work is an important addition to our knowledge of the subject—how a central bank should meet the challenge of development.

Oct. 31, 1976

S. N. SEN
Vice-Chancellor, Calcutta University

Preface

This work attempts to answer a few basic questions on the working of central banking in India. It is partly the product of my personal experience of the working of the Reserve Bank of India for half a decade. The initial apprenticeship with the Reserve Bank has given me an opportunity to observe closely the practical working of a central bank in an underdeveloped economy. In addition, this work sums up my studies, pursued over a long period of time, on the problems of developing economies and the ways in which monetary policy can aid the process of growth.

A central bank is a political institution, almost by necessity. It is set up by an act of the legislature, and it usually has some direct connection with the Government. The governing board is appointed by the President or the Prime Minister; the Chancellor of the Exchequer may also be a member of the board. In any case, a contemporary central bank has control over the economy's money supply and this function cannot possibly be left in the hands of private individuals who usually act under principles of self-interest. *Ipso facto,* a central bank is a part of the political structure. Given this position, how is the central bank to be made responsive, responsible and an object of democratic processes? I have examined the records of the Reserve Bank of India in order to see how far it is so structured, how much its actions in changing the money supply could be attributed to scientifically verifiable economic factors that the economy was experiencing and to what extent to political factors.

A 'political factor' would be a special pressure group, for example, Parliament which favoured lower interest rates no matter what the side effects might be, or another group that wanted to discourage imports. Either or both such groups might well try to influence central banking policies in their own favour. It is almost impossible to achieve an agreeable consensus of opinion especially between economists and politicians. Monetary policy is quite controversial, economic and political opinions on what should be done are too diverse for any acceptable line of policy action which could hardly be compromised. 'Non-political' monetary policy is a contradiction in terms. It implies that both the policy ends and means are 'scientific' and subject to no difference of opinion. An institution that operates under such false pretences becomes authoritarian if there arises a controversy over what ought to be done, but it is overlooked or ignored by the inflexibility of the institution. This forms a broad area of discussion in this work and marks an advance on earlier studies.

The last twenty-four years of economic planning (1951–1975) in India have been a period of intense economic activity and the functioning of the central banking institution in India has acquired a new outlook with a new sense of purpose, direction, and dimension in the context of planning for economic development. Development schemes and their successful implementation depend upon the correct and balanced policies adopted by the central monetary authority in the country. Greater importance has come to be attached to central banking as an essential element of economic planning. The principal purpose of this work is to evaluate critically the dynamic role of the Reserve Bank of India's monetary control policy in the context of planned economic development. It seeks to study and analyse the new trends of monetary management introduced by the Reserve Bank of India in the wake of economic planning. My approach has been to underline the quiet revolution that has taken place in the role and function of the Indian institution during the last two decades and a half. It endeavours to explore how the Reserve Bank is drifting steadily from its orthodoxies to bolder policies of monetary administration in order to suit the structural requirements of a planned economy like that of India. The examination of the different aspects of the Reserve Bank's policies is characterised by a realistic awareness of the magnitude of the Bank's problems and the limitations of the instruments with which it has to tackle those problems.

Structurally, this work is divided into three parts. The first part (Chapters 1–5) attempts to analyse the *regulatory* role of the Reserve Bank of India. With respect to its regulatory role, the Reserve Bank of India's moneiary policy has been oriented to the national objective of economic growth with stability. The second part (Chapters 6–13) makes a critical appraisal, from a theoretical as well as a practical plane, of the *promotional and developmental* role of the Indian central banking institution. In fact, its promotional and developmental role has been more predominant than its regulatory role. But there is no inherent contradiction between these two. The two may be coordinated so that one tends to fortify the other. The third part discusses in detail the *political* role (Chapter 14) of the Reserve Bank of India with special reference to its changing relationship with the public, politics, political authorities and the Government.

A primary aim of bank nationalisation was to convert banking of the classes into banking of the masses. A critical assessment of the performance of the public sector banks during the six-year period of nationalisation (July 1969–July 1975) has been made and the central banking policies in relation to the state-owned banking sector have been carefully analysed (Chapter 13). A painstaking investigation regarding coordination between commercial and cooperative banking, costs and capital structure of banks, restructuring of the banking system, nonbanking financial intermediaries, indigenous bankers, banking regulation and proposed rural banks has been carried out in the light of the Report of the Banking Commission, 1972. A central banker in the postnationalisation era is not just a controller of funds, but an innovator of economic and social change in the community.

The exploration has been carried out from authoritative sources such as the Reserve Bank of India publications and reports, foreign central banks' charters,

annual reports and statements of accounts, economic and financial bulletins and reviews, statistical and other publications. Use has also been made of the statutes and articles of association of various development banks operating in some of the Asian and African countries, their annual reports and explanatory memoranda, etc.

It is not possible to give proper credit to all who have given me substantial assistance. They include many commercial bank officers, security dealers, and the Reserve Bank officials—all of whom were most cooperative and generous. Frankly, my intellectual debt to the literature on the subject is far greater than the footnote references to specific sources might suggest. I am deeply indebted to Dr S. N. Sen, Vice-Chancellor, University of Calcutta, and Dr D. S. Ganguly, President, West Bengal Council of Higher Secondary Education, Calcutta, who have made most valuable suggestions for the improvement of this work. None of these economists is, however, in any way responsible for the views expressed in this monograph.

Letters from a number of scholars, including R. S. Sayers, formerly Sir Ernest Cassel, Professor of Economics at the University of London; Richard H. Timberlake, Jr., Professor of Finance and Economics, University of Georgia; W. Scott Bauman, Head, Department of Finance and Business Environment, University of Oregon; Dr W. Randolph Burges, Chairman, the Per Jacobsson Foundation, Washington, and Dr Edward W. Reed, Vice-President and Economist, United States National Bank of Oregon, in reply to my queries have also been very useful indeed. I express my indebtedness to them for their help and cooperation. Dr Sid Mittra, Professor of Economics and Management, Oakland University, Michigan, has indeed laid me in a deep debt of gratitude for his gracious letters and wise counsel. To him I owe much. Also I must sincerely acknowledge the thoughts of the immortal J. M. Keynes, R. G. Hawtrey, I. Fisher and a galaxy of bright names that adorn the pages of the history of monetary economics, which guided me in the preparation of this work.

In particular, I remember with gratitude the illuminating observations that Prof. Timberlake made by way of explaining many an important issue that cropped up in the course of the present inquiry.

I have desired in every chapter to write something original and useful to the reader and if in any part of this monograph I should give expression to anything wrong, I here declare once for all my entire willingness to be forgiven.

C. R. Basu

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PART TWO

ECONOMIC ROLE : PROMOTIONAL AND DEVELOPMENTAL

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Nomenclature

The Reserve Bank of India is the central bank for India. Scheduled banks are analogous to the member banks in the United States. The Indian currency is the rupee.

Exchange Rates (Approximate Conversion Table)

STERLING		*as on October 1, 1976*
Selling	..	Rs. 15.00 = £1
Buying	..	Rs. 14.40 = £1
US DOLLAR		*as on October 6, 1976*
Selling	..	Rs. 9.00 = $1
Buying	..	Rs. 8.60 = $1

(The foreign exchange rates are subject to daily fluctuations depending upon the foreign exchange market conditions.)

Million = 0.1 crore or 10 lakhs

PART ONE

Economic Role: Regulatory

1

Introduction

This work looks for answers to certain fundamental questions on central banking policies and operations. A fundamental question to ask oneself on the role and function of a central bank is what this institution has done to the money supply over time with respect to (i) prices, (ii) production, and (iii) other factors such as politics, etc. The basis for evaluating its role with respect to planning is the degree of control the Indian institution has over the money supply and how it has managed the monetary system. This project is intended as an original and independent investigation of central banking policies and operations in the context of the planned economy of India. It is partly the product of practical knowledge of more than half a decade in the functions and working of the Reserve Bank of India. The initial apprenticeship with the Reserve Bank has fortunately given the author necessary insights into the problems of its management of the country's monetary policy. The study also embodies the result of original research carried out by the author. It is based mainly on his own observations of new facts and partly on new relations of facts observed by others. Economists have been rather reticent as to the role of the central bank in the planned economy. With the exception of Professor Lester V. Chandler,[1] very few writers have studied the problems faced by the central bank in promoting the growth of a national economy in the context of planning. The present work is an attempt to fill this gap and thus claims to be a genuine addition to the meagre literature on the subject. The investigations, therefore, are offered as a contribution towards the general advancement of knowledge.

II

Today economic growth is being increasingly considered to be the most important objective by almost all underdeveloped countries which are labouring under a low level of material well-being. It is now generally believed amongst the underdeveloped countries that the process of economic growth can be accelerated by applying the technique of planning. By integrating the fields of central

[1] Chandler, L. V., *Central Banking and Economic Development*, University Press, Bombay, 1962.

banking with economic planning of underdeveloped nations, this study presents a new understanding of the dynamic role which a versatile and percipient central bank could play to aid the process of economic growth. More precisely, this work describes the central banking mechanism with particular emphasis on the changing role of the Reserve Bank of India in the context of economic planning and development and explains how the present-day attitudes, policies, and practices have evolved and suggests some possibilities of future changes.

Costs of development are greater today, fields for development are wider, and social consciousness is much more awakened than ever before. Consequently, it is necessary in a developing economy to take positive steps to ensure that the best possible use is made of the limited resources available. It has also to be ensured that the country's affairs are so organised that sufficient wherewithal for its development is generated and mobilised for the purpose.

Democratic planning in India began in 1951. With the acceleration of planning efforts, exceptional stresses and strains developed in the economy which challenged the Reserve Bank to reformulate its monetary policy in a way which would curtail the flow of credit into undesirable channels without bringing about a contraction in the total quantum of credit. How well the monetary authorities have met this challenge has been a major area of discussion. In the final analysis, it has been established that the ultimate success of monetary policy in all developing economies will depend in a large measure upon the skill and open-mindedness of the monetary authorities to adapt constantly the technique of central banking to the ever changing national economic situation. The climate of opinion and expectations has now changed since the days of the Brussels Conference of 1920. Today few central banks think of their functions merely in terms of securing price and exchange stability; they all lay stress equally on growth and stability.

Economic growth implies increased output of goods and services (with no greater cost in terms of effort and sacrifice by the populace) at a rate faster than the rate of increase in population, so as to have a diffused increase in income throughout the population. Furthermore, in order to sustain this growth, the forces initiating it must continue to operate for several generations until the economy is able to develop sufficient motive power to go forward on its own momentum towards higher levels of production. Economic development, on the other hand, is the rapid creation of a complex of favourable conditions encompassing economic, political, sociological, cultural, and other non-economic factors, at a rate promising an all-round improvement in the individual's level of well-being. The developed countries have accomplished what the developing countries are trying to achieve. They do not need development but growth—higher production and higher incomes—so that they are able to judge their performance from year to year by the actual rate of growth achieved. In developing countries, on the other hand, the problem is much vaster. The growth rate is important to ensure that every one has enough to eat, but other considerations claim attention too. Unlike developed countries, developing countries have to concentrate not only on growth but also on building up the potential for future growth. Measures to improve the health and education of

the people, to improve the transport system, etc. help to build up a potential for future growth, even though their contribution to an immediate increase in the national income may be small or negligible. Thus, while a developed economy needs just growth, an underdeveloped economy needs development. Manifestly, the problem facing all developing nations is one of economic development rather than mere economic growth. Since central banking policy influences economic factors, the role of the central bank will be examined primarily in relation to economic growth in India in this study. Reference to the non-economic aspects of India's development problem, however, will be made to give a perspective of the complexities of India's development planning.

III

Against the wider international background, the role of the Indian central banking institution particularly, has been studied as a piece in the whole mosaic of the planned economy. The work seeks to explore how far the techniques followed in the developed, underdeveloped and emerging countries have found their place in the Indian central banking experiment so far and what other innovations are needed for the attainment of the objectives of economic growth. The trends and progress of Indian central banking in the planning era have been juxtaposed against the experiences and lessons of the contemporary central banking systems of the developed, underdeveloped and emerging countries in order to indicate the lines along which the Indian central banking policies and practices should move in the interest of a developing economy. In fact the period under review (1951–1975) is replete with far reaching and significant developments in the field of international banking—it has such a wealth and variety of central banking experience, the problems it has faced and the solutions it has attempted have been so varied that it has been thought profitable to consider all these carefully and learn the lessons taught by them.

The study investigates to what extent the Indian institution lives up to the dictum that "the cardinal virtue of the central banker is not conservatism in technique, but rather a disposition to discover novelties and to be versatile in technique".[2] It gives a fairly precise and exhaustive view of the problems of monetary policy in the context of India's development planning. The examination of the different aspects of the Reserve Bank's policies is characterised by a realistic awareness of the magnitude of the Reserve Bank's problems and the limitations of the instruments with which it has to tackle those problems. It has been argued that the task the Reserve Bank was asked to perform in the planning era was a difficult one; to act as the credit creating machine, while at the same time restricting the effects of excessive credit creation. The Reserve Bank of India is still living with this problem in monetary policy and plays a passive role under the dictates of fiscal policy.

The regulation of money supply is not wholly, or even largely, under the Reserve Bank's control. It is considerably affected by the budgetary operations

[2] Sayers, R. S., *Central Banking after Bagehot*, Clarendon Press, Oxford, 1957, p. 33.

of the Government, over which the Reserve Bank of India has no control. Since the monetary authorities were obliged to act as the prime source of monetary expansion in the Indian economy by extending the requisite amount of credit to the Government, and since the monetary policy was called upon to play only a passive role, the blame for inflation rested primarily on the Government which directed the total economic policy of the country. As the central bank is a part of the apparatus of the Government, and monetary instability might endanger Government's own plan objectives and may retard even economic growth itself, there must be close and continuous consultation on monetary policy and fiscal policy between the Government and the central banker. The Governor, all the Deputy Governors, and the Directors of the Reserve Bank now are nominated rather than promoted from among the technical people in the Reserve Bank itself. If there were to be a greater number of technical men rather than civil servants in the Reserve Bank's top management the chance of such friendly and fair consultation would be possible and may even yield the desired results. This is a major thesis of the study (Chapter 14).

Increase of growth is a long-term objective, but in the short run, price and exchange stability may command immediate priority. The decision as to which is more important at any given time has, in the last analysis, to be a practical decision. This needs a close understanding between the government and the central bank authorities of a country, and the cooperation of both in the furtherance of the economic development.

The role of the central bank in a developing economy is essentially that of balancing the various objectives both in the long run and in the short run. There cannot be sustained growth without some degree of stability. In view of this, there should neither be any conflict between monetary policy and developmental policy, nor should there be any conflict between the different objectives of monetary policy.

One of the basic problems facing the developing nations is related to the shortage of capital. In addition to creating appropriate political, social and cultural conditions, the government must find additional investment capital if it desires the nation to grow. Most governments favour a planned supply of investment capital and embark upon long-range economic plans. It is in this context that monetary management assumes special importance. Economic planning is unthinkable without monetary management, and monetary management is doomed to failure without economic planning.[3] Monetary management assumes even more significance in the context of the economic development of underdeveloped countries. In these countries, because of the inadequacy of savings and the difficulty of directing the low volume of savings into productive investment, there is usually a strong temptation on the part of the governments to raise the level of investment by expanding credit. Such development efforts in most of the less developed countries have, in the postwar period, been accompanied by an inflationary price increase.[4]

[3] Einzig, Paul, *Monetary Reform in Theory and Practice,* Macmillan Company, New York, 1936, p. 126.

[4] "Inflation, Deflation and Economic Development," Staff Papers, VIII, 1960–61, IMF, p. 101.

It is, however, widely agreed[5] that the policy of development through inflation in underdeveloped countries can be successful and meaningful only if inflation is effectively controlled. It is in this context that monetary policy assumes such great importance. Even within the broad framework of stimulating economic growth through inflation, no one type of monetary policy is suitable in all circumstances. The central monetary authority has to devise a policy which will suit its country best. This, in turn, will depend largely upon the stage of development of that country's financial institutions as well as on the prevailing monetary and banking traditions. It is through constant changes in the technique of monetary management and also through the development of new instruments of credit control that the central bank can help to bring about rapid development with stability.[6]

There is a major difference between the more developed and the less developed countries which is of particular significance in this context. The former have, in most cases, an efficient and well-differentiated structure of financial institutions while the latter are seriously deficient in this respect. There are, again, differences in the degree of such development as between the less developed countries *inter se*. Some of the smaller ones among them have very little of commercial banking or a money market, in controlling or directing which the central bank needs to expend much energy or ingenuity. In such situations, the central bank has to take on a positive developmental role and seek actively to build up, extend, and strengthen the country's banking and financial structure. Extension of banking facilities, both for mobilisation of savings and for channelling of credit into productive and promising sectors, is an important and integral aspect of economic development. It is not only legitimate, but well-nigh inevitable, that the central bank should assist actively in mapping out the tasks to be taken in hand and in setting up or managing appropriate financial institutions.

The development of an adequate credit organisation calls for, apart from institutionalisation of savings and investment, a wide geographical coverage to serve the public. This is necessary not only to cater adequately to the financial requirements of the public in general, but also to promote their savings habit through deposit investment of such savings in these institutions. A large number of points of deposit collection always attracts a large quantum of deposits. The expansion of the coverage of the commercial and cooperative banks, both geographically as well as functionally, thus assumes great importance.

IV

This research project concerns itself with the role of the central bank in the development process of an underdeveloped country, namely, India. Perhaps, the world has rarely observed a central bank taking so active a part in the economic development of a country, or departing so widely from orthodox concep-

[5] "Measures for the Economic Development of Underdeveloped Countries," United Nations, New York, Sales No. 1951 II, B. 2, 1951, p. 42.

[6] *Economic Development with Stability*, IMF, Washington, D.C., 1953.

tions of central banking. This study explores how far the Reserve Bank of India has been successful in assisting the Government in speeding up the processes of economic growth in India during the development planning period and to what extent this growth has been achieved in an environment of reasonable stability. An analysis of the major problems confronting India in her effort to develop the country clearly brings out that these problems are two dimensional. Some of these problems are sectoral, while others are aggregative. Although, both are equally important, this investigation confines itself mainly to the study of aggregative problems. More precisely, this work unfolds the aggregative problems created in an effort to achieve an accelerated development in India through Government sponsored Five Year Plans and the role of monetary policy in tackling the problems and promoting economic growth. A criticism of the monetary policy in a developing economy must necessarily be based on its achievements and failures in terms of planned development of the country over a given period. Our concern is, therefore, mainly with the monetary aspects of the nation's economic development in the planned era.

Some economists argue that monetary policy must be used to provide the correct amount of money consistent with higher levels of economic activity.[7] An adequate supply of money is a necessary though not a sufficient condition for economic growth. A country must have an appropriate degree of monetary expansion to meet the increasing requirements of a growing economy. The aim of a central bank in a developing economy has, therefore, to be the adoption of adequate policies which aim at bringing about an appropriate degree of monetary expansion along with price and exchange stability. A conscious control needs to be exercised over the money volume in keeping with the desired level of economic activity. The role of a central bank, and an important one at that, is to have a monetary policy which will facilitate a proper degree of expansion of money supply in the long run but, should the price situation demand it, pull the reins back in the short run. Further, monetary policy in such a country has also to provide for the mobilisation of resources to the maximum possible extent, as well as provide for their most efficient investment for purposes of development.

Central banks are concerned today not only with the control of the total volume of credit but also with the flow of credit into specific sectors of the economy. In India, for instance, the Government of India has stated that:[8]

> Central banking in a planned economy can hardly be confined to the regulation of the overall supply of credit.... It would have....to create the machinery needed for financing developmental activities all over the country and...in ensuring that the finance available flows in the directions needed.

Traditionally, the major responsibility of a central bank of a developed nation is considered to be the use of general and selective instruments of credit control with the prime objective of maintaining monetary stability in the country.

[7] Whittlesey, C. R., "Relations of Money to Economic Growth," *American Economic Review*, papers and proceedings, Vol. XLVI, No. 2, May 1956, pp. 188–201. H. S. Ellis, however, belongs to the opposite camp, see *American Economic Review*, op. cit., pp. 206–10.

[8] *First Five Year Plan*, Government of India, Planning Commission, New Delhi, p. 38.

The role of a central bank is, therefore, characterised primarily as regulatory. In India, the central bank has to operate in an institutional setup of a mixed economy, heavy public expenditure under a planned development programme, the existence of a large and important private sector, an indigenous juxatposition of a highly organised and an unorganised money and banking sector, and above all, the existence of a primitive barter economy. Under conditions such as these the central bank must actively assist the Government in its planning efforts to the maximum possible extent so that the development process gains momentum. In order to do so, it may have to shift the emphasis of its policy from the regulatory to promotional and developmental aspects.

V

The regulatory function of the monetary authorities is called the restrictive role of monetary policy. This might also be called the short-term objective of controlling inflation. More specifically, when the Government decides to pursue the inflationary method of financing development, the monetary authorities charged with the responsibility of controlling the inflation generated in the economy must not only use the quantitative instruments of credit policy more vigorously, but must also be versatile in developing qualitative controls best suited to the needs of the particular stage of development. Besides the restrictive aspect, monetary policy has an additional and perhaps more important role to play. A developing economy requires firstly, an increase in the total volume of savings; and secondly, the setting up of an institutional structure which specialises in the collection of savings and the profitable investment thereof consistent with the objectives of planning. Though the first is primarily a problem of overall economic policy the central banking policy also plays an important role in it. The second is what one would call the promotional role of a central bank. This must include, if it is to be comprehensive enough, steps to meet the needs of sectors where adequate resources are not available.

A thorough investigation has been made of the promotional and developmental role of the Reserve Bank of India in the realm of rural credit and industrial finance. We have challenged the prevailing view that the Reserve Bank of India, at the present stage of economic growth, should now 'withdraw gracefully' and operate as a distinct institution. It is difficult to agree with the naive contention that the Indian institution has been continually 'diluting' the essence of central banking by extending more and more the scope of its functions beyond the frontiers of central banking proper.

In a developing* stage of the economy, a central banker can extend the scope of his promotional and developmental functions without affecting in any way the quality of his leadership in the money market. In an underdeveloped country like India, the central bank, as the 'watchdog' of the monetary system, undoubtedly has to step in and fill the gaps in the financial structure wherever

* The words 'underdeveloped', 'developing' and 'emerging' have been used interchangeably in this study.

they exist. Though India is progressing in the stages of its economic growth, the time has *not* yet come for the Institution to abandon its promotional role.

The central banker in an expanding economy has thus emerged as a powerful 'presiding deity' in the money and capital market with the promotional role of initiating and developing financial institutions in the fields of agriculture, industry, and trade. The 'involvement' of the Reserve Bank of India in institutional development, whether in agricultural, industrial, or trade finance does not imply the substitution of its judgements for those of the financing institutions concerned. The responsibility has remained, and must remain, with the banks or the term-lending institutions themselves.

The promotional role of the central bank in an underdeveloped country may be reviewed in relation to the part it has played, and may further play, in the development of broad and well-organised money and capital markets; in the creation of banks and other financial intermediaries; in promoting the growth of cooperative credit societies so as to provide an institutional framework favourable to rapid agricultural, industrial, and export growth; in acting as the Government's financial and foreign exchange adviser; and generally in implementing its overall economic policy.

The promotional role is the long-term objective of developing financial institutions. While both restrictive and promotional roles are of importance for a successful credit policy, clearly there is no magic formula by which the monetary authority can determine in advance the course of action that will satisfy both objectives at all times. On several occasions, it will call for the revaluation, and conceivably a realignment, of monetary policy with the total economic policy of the country with the prime objective of achieving the desired goals set by the community in the most efficient way.

The central bank in an underdeveloped country has a twin role to perform; that of a regulator as well as that of a promoter. Such a central bank has been regarded as an engine of growth. In the circumstances, the promotional or developmental aspect of the central bank's role has come to be considered as more significant than its regulatory aspect. There is no inherent contradiction between the two roles; they may be coordinated with each other or one may even be superimposed upon the other.

VI

Since the present study is concerned with a critical examination of central banking policies and operations in the Indian context, the problem of economic growth with stability has been a major part of our discussion. It has been established in the course of our analysis that one of the important alternatives open to the growing nations is to resort to inflation as a deliberate policy for the long-term objective of rapid economic growth. Under a variety of favourable conditions, a slow rate of inflation is likely to step up the rate of real investment and capital formation. Only if the rate of growth of inflation is lower than the current money rate of interest, will the investors be encouraged to invest in longer-term income-yielding assets which are more favourable to growth. But

this potential cannot be realised if the evils of inflation are not explicitly recognised and scrupulously avoided. Of course, a spiral process type of inflation must be excluded from this discussion since it serves to retard rather than accelerate development. An initial impulse type of inflation is like a habit-forming drug which has to be used in increasing doses in order to maintain the initial effect and care must be exercised to prevent it from turning into spiral inflation.[9] Inflation of the initial type generated as a deliberate policy of growth must be self-liquidating within a given period of time. For, if this is not the case, the initial inflation will invariably start the spiral process which would signify that the economy is sick rather than growing. On the whole, the necessary institutional conditions are largely unfavourable in underdeveloped countries for pursuing a successful inflation policy. The types of policies called for in this regard are politically very difficult and administratively onerous to implement.

It is well-known that continuous inflation is corrosive of confidence in money and ultimately of investment.[10] So, the control of inflation should be one of the major objects of economic policy in a developing economy. To control the inflationary strains the Reserve Bank applied, in varying degrees and frequency, all the monetary brakes in its possession. The success or failure of monetary policy, however, depends to a large extent not only upon the dexterity with which these brakes are applied, but also significantly upon the structural framework within which monetary policy functions.

VII

If it is found, even after the general credit restraints have been in operation, that there are certain 'pressure points' left that cannot be tackled or touched by purely quantitative methods, it may be useful to combine such methods with selective credit control operations. The Reserve Bank of India's experiment with selective credit-cum-portfolio-ceilings control was carried out during a period of continuous inflationary pressure since the beginning of the Second Plan. The success of selective credit control will depend more on the cooperation of the banks than on the nature of the money market. One must recognise that these control measures are seldom quick in action. There will usually be a considerable time lag even when they can be made fully effective. The larger the number of banks to be covered by this method of control, the greater is the likelihood of administrative difficulties. The chances of its success are more where the number of sectors to be covered is small and where banks have a tradition of soundness and solvency. The possibilities of evasion are great especially in an underdeveloped economy which is characterised by undeveloped law-abiding habits. On balance, their effects are likely to prove beneficial in enabling the central banker to prevent sectional inflation in the economy.

[9] For evils of inflation, see Chandler, L. V., *Central Banking and Economic Development*, op. cit., pp. 36–43.

[10] *The Per Jacobsson Foundation Lecture*, May 1968, on "Central Banking and Economic Integration," by Dr. M. W. Holtrop, pp. 22–29.

VIII

With the growing pressure on monetary demand and continuous worsening of the price situation, the device adopted by the Reserve Bank of India was that of progressively rising penal rates of interest on different slabs of borrowings by the scheduled banks. The persistent rise in credit expansion by resorting to increasing borrowings proves adequately that the quota-cum-slab lending policy has little effect on borrowings by the banking system. The deployment of a new controlling device was, therefore, called for by which the borrowing power of the bank was related to its net liquidity. The more the borrowings, the greater the impairment of net liquidity. The mechanism is self-correcting in its operation as the excess of borrowing cost from the Reserve Bank over the maximum at which a commercial bank can lend cannot obviously be prolonged. The banks cannot afford to have an adverse divergence between the marginal cost of raising funds and the marginal revenue from credit operations. It is thus designed to impose a restraint on heavy and prolonged use of such credit.

Evidently, the objective of control of access right by the new device of higher liquidity ratio requirements was to neutralise a part of the liquidity of the banking system and to limit the expansion of bank credit. The effect, on the whole, combined with that of the other monetary measures taken should be to exercise a downward pull on inflationary pressures. In fact, the Reserve Bank of India's approach to the matter does not seem to be in keeping with the developmental tempo. The Indian central banking institution should not only have introduced measures of control over the volume of money supply by raising the cost of credit and regulating the right of the banking system of access to it, but more importantly, it should have kept watch on the end-use of bank funds in productive and quick-yielding assets so as to overcome the adverse effect of inflation. But this was sadly lacking. It is the duty and responsibility of the central banker in an underdeveloped economy which is passing through inflationary strains, to aim at encouraging larger expenditure of bank credit on production of those commodities and services that have high development potential.

The ineffectiveness of the monetary measures stems from the fact that while the credit expansion in the private sector is curbed, the Government's expenditure has been mounting by leaps and bounds. As a percentage of national income (1948=100), the wasteful expenditure has gone up from 6.1 per cent in 1950–51 to 18 per cent in 1964–65.[11] Because the unproductive expenditure, which has a direct bearing on the liquidity in the economy, has been snowballing since the beginning of the planning era, the best alternative left is to scale down non-developmental and non-Plan expenditure. Wasteful use of funds on unremunerative schemes taken up for political or other non-economic reasons and low-yielding forms of investment must be reduced to the minimum. It is likely

[11] *Capital Annual Number*, Calcutta, 1965 (p. 29). It is estimated that the percentage is still higher in the Fourth Plan (1969–74).

that 'black money' too has played an active part in accentuating inflation. The monetary authorities have paid little attention so far to the problem of unearthing unaccounted money.

The Reserve Bank of India has been caught in a vicious circle in the course of implementing the policy of 'controlled expansion', a synonym for the term 'growth with stability'. Money supply is expanded to meet the growing demands of productive sectors in a developing economy. This tends to create inflation which, in turn, raises the financial needs of the productive sectors. To meet the legitimate needs of these sectors, still more money is injected into the market which, in turn, produces more inflation. Once speculation is sought to be controlled through a tight money policy, the productive investors are also hurt because their need for funds is a rising function of inflation. Therefore, within the framework of this policy there is no escape—production and prices escalate together but the latter stay ahead of the former.

IX

In the ultimate analysis, the effectiveness of monetary policy in its restrictive role will mainly depend upon the success with which it performs its promotional role. An appropriate monetary policy in the context of growth of an underdeveloped economy will need to concern itself with the development of a financial system which will prevent inflation or deflation without impeding the adjustment of production and prices that constantly takes place in a dynamic economy. Simultaneously, the policy will have to be selective enough to influence the pattern of investment. The monetary policy will have to be formulated in a way which will function effectively as an integral part of the total economic policy.

Exclusive reliance upon monetary policy as a means of coping with inflation and also dealing with the problem of development of financial institutions is 'dangerously one-sided'. No attempt has been made to emphasise the effectiveness of monetary policy for the preservation of monetary stability. Discussion has been confined to monetary policy because that is the subject matter of this investigation. The point we have stressed is that the scope of monetary policy is larger than is generally supposed and that it is expanding. But it can make only a limited impact on inflationary pressures unless steps are taken in the fiscal and administrative fields also. Steps have also to be taken by all sectors of the general public for it would be a profound mistake to think that the task of maintaining monetary stability is the task of the Reserve Bank of India only. Discipline, hard work, and integrity all around are necessary. In other words, the attempt has to be manysided, and in this attempt monetary policy undoubtedly occupies an important place.

The two major constraints on growth in India have been the shortage of savings in relation to investment needs and the inadequacy of foreign exchange. Clearly, in order to stimulate growth it is necessary to make heavy investments but this is hampered by the shortage of savings. As a result there is both the pressure and the temptation to expand investment through deficit financing or credit

creation. Either of these, unless their volume and their timing are carefully determined, will lead to excessive monetary expansion and an upsurge in prices. Therefore, the danger of an inflationary price rise remains a constant menace to the process of growth.

In Indian conditions food supply is a major factor which has a bearing on the problem of inflation and safe limits of monetary expansion. The increase in income resulting from a step-up in investment generates a marked increase in the demand for food, particularly during a period of 'population explosion'. A demand-generated inflation of food prices thus tends to become a cost-induced inflation of industrial prices. Such inflationary pressures during the Second, Third, and Fourth Plan periods (1956–74) threatened the whole concept of real growth of the economy through planning.

The responsibility of preserving the stability of the national currency is not confined to central bankers of underdeveloped countries alone. Even in an advanced country like the USA the maintenance of the value of the dollar is frequently emphasised. Thus the Chairman[12] of the Board of the Governors of the Federal Reserve System observes:

> What a correct monetary policy can do is to foster confidence in the dollar, so that our people can and will save and invest in the future with reasonable assurance that their plans will not be frustrated by irresponsible changes in the value of money.

India did well in comparison with the Latin American countries in which inflation became a way of life and was institutionalised into the legal and socio-economic structure of the country. The Indian institution, however, failed to accomplish the delicate balance between the two aims: growth as well as stability.

The first sentence of the *Approach to the Fourth Five Year Plan* reads, "Growth with stability is the main aim of the Fourth Five Year Plan." The implication of this is that if stability is not to be endangered, we have either to be ready to mobilise adequate resources to sustain the desired rate of growth or we have to plan for a lower rate of growth. The central banker has the noble task of ensuring the maintenance of stable money which goes hand in hand with a high level of civilisation.[13] Confidence in money is essential to continuing and enduring prosperity.

X

A passing reference to an interest policy for India has been made at the appropriate places. A mere rise in interest rates may not necessarily mean decreased availability of credit. Whatever immobilisation of balances took place following measures of credit squeeze and the regulation of access right of the banking system was easily neutralised by drawing down cash balances

[12] Martin, William M. Jr., "Monetary Policy and Economic Growth," *Federal Reserve Bulletin*, XLVI, No. 2, Feb. 1960 (Statement made before the Joint Economic Committee, Washington, D.C., Feb. 2, 1960).

[13] *The Per Jacobsson Foundation Lecture*, November 9, 1966, "Introductory Remarks," by Donato Menichella, Honorary Governor, Banca d'Italia.

and through the sale of securities to the Reserve Bank. The existence of high interest rates reflects the growing scarcity of capital resources under the stimulus of the Five Year Plans; if the Reserve Bank's measures hastened the rise in rates, they served just to bring the economy nearer equilibrium. There was a good deal of buoyancy and speculative fervour in the capital and commodity markets. The optimistic outlook of the business community raised the demand for funds and, consequently, the rates of interest. Since a rise in interest rates may raise costs of production and so prices, it may not be looked upon with favour. But higher interest rates, by raising costs, may prove to be a deterrent to investment expenditure, and that was also the objective of the Dear Money policy pursued by the Reserve Bank of India in the Plan period.

It may be pointed out in this context that there is a disparity in the rates of interest in the organised and unorganised sector. This disparity should be eliminated so that any trend towards the flow of funds into the unorganised sector in search of higher interest yields might be counteracted.

The bank rate by itself is not a powerful instrument of interest rate policy. The impact of the bank rate on the money and capital markets has not been significant as it relates only to the borrowings of the scheduled banks from the Reserve Bank of India. It forms only a small segment of the whole interest structure which regulates the flow of funds to different uses. To ensure that the flow of finance to different sectors is in accordance with the objectives of economic policy of the planned economy, this sphere of regulation has necessarily to encompass the whole structure of interest rate.

A balanced structure of interest is a prerequisite for a proper distribution of resources between different sectors of the economy and between different uses. The allocation of resources by these sectors is broadly outlined in the Plans which also indicate the sources from which the investment programmes will be financed. To achieve this pattern of financing the structure of interest rates must be appropriately shaped. Unfortunately, the interest structure has been found to be imbalanced, particularly in the Third Plan period even though the Reserve Bank of India and the Government have a variety of instruments at their disposal to regulate interest in almost all important ranges.

XI

A critical and searching analysis has been made of the nature of growth and composition of the investment portfolio of commercial banks in the Plan period. Seasonal variation in the investment portfolio is gradually lessening with the rise of the industrial economy. With the progress of industrialisation, the non-agricultural sector expands and the bank advances against these commodities increase. These factors moderate considerably the seasonal variation in bank credit for agricultural commodities. Lately, there has been a marked surge of bank investments in the short-dated Government securities.[14] The

[14] During the closing years of the Fourth Plan (1972–74), investments recorded a marked shift in favour of medium-shorts (5–10 years) quite in conformity with the inflationary price level.

marked preference for the short-dated securities is possibly an attempt to keep the liquidity in readiness to respond to the growing demand for the bank funds in a developing economy. The shift in the maturity distribution in favour of the short-term group is due to the fact that during a period of rising price levels depreciation in the value of short-dated securities is comparatively small. The explanation for the present trend for shortening of the maturity pattern may be found in the banks' expectations about the rise in the future interest rate also. A note of caution has been sounded as to the wisdom of the statutory obligation of the commercial banks to maintain 33 per cent of their deposits in Government securities that yield a low return thereby causing erosion of profits. The statutory obligation of keeping a high percentage of deposits in Government securities tends to curb the power of the banks in extending credit to the desired sectors.

The rate of interest of Government securities must bear a proper relationship to the yield on debentures, preference shares, and equities so that the distribution of resources between the two sectors and between different uses will be such as to promote the highest growth.

A reorientation of outlook is necessary to create dynamism in a developing economy. It has been logically established that term-financing by the commercial banks will not jeopardise their liquidity position, rather judicious term-loans and an active vigilance towards their prudent application will tend to strengthen the banking structure. A more purposeful advent of the commercial banks into term-lending is bound to bring them into a closer relationship with the development banks and a clear demarcation of their respective spheres of activities seems to be well-worth consideration.

The respective roles of the commercial bank and the development bank have been fully examined and it has been found that in spite of the strong emphasis on the efficacy of the development banks, the contribution of the commercial banks to the economic growth seems to be more important in bringing about a healthy national economy. Despite the proliferation of specialised institutions after World War II they appear, quantitatively, to play a relatively small part in industrial financing. It has been argued that with proper authority and scope, the commercial banking sector will be able to assert its position in the realm of development finance. Bold and uninhibited encouragement from the central monetary authority is needed to give an impetus to the commercial banks. As Mr. Diamond[15] puts it:

> Given effective instruments of monetary policy, adequate bank inspection, a central bank prepared to provide discriminating liquidity, and an understanding of the varying liquidity requirements of the different types of resources at the disposal of a bank, the marriage of commercial and investment banking is safer and more effective....

The proliferation of development banks and their overlapping areas of functioning have been carefully studied. The mushrooming and overlapping of these term-lending institutions is puzzling, it reflects the persistent efforts

[15] Diamond, William, *Development Banks*, Economic Development Institute, Johns Hopkins Press, Baltimore, 1957, pp. 31 and 44.

of the Reserve Bank of India to rectify the previous failures of their half-hearted efforts.

The Industrial Finance Corporation of India (IFC), formed in 1948, has already been playing a significant part in the financing of the industrial development of the country. The promotional nature of the Corporation's activities has steadily increased and it has already gathered a wealth of experience in the field of development banking. The Reserve Bank of India should have displayed a heightened awareness of the exigencies of the situation by transforming the IFC into the IDBI, it would have been a natural and desirable move. But the creation (in 1964) of this new institution will, in the long run, seal the fate of the IFC, one of the finest development financing institutions operating in any underdeveloped country today. In a developing economy the promotional role that a central bank has to play undoubtedly involves the assumption of diverse functions. What has been emphasised in our study is that instead of sponsoring another innovation, a more fruitful step would have been to combine the National Industrial Development Corporation (NIDC) with the IFC—synthesising the accent on promotion and development of the former with the emphasis on financing of the latter.

Development of export trade is essential to make the economy self-reliant and self-sustaining. The export credit system of India has been studied in detail with particular reference to the costs of export credit at various stages and the mechanism of the Reserve Bank refinance from the point of view of the adequacy of incentives provided in it to banks for expanding export credit. In India the banking system is still immature, especially in the field of export trade. Sound banking traditions for providing cheap and adequate export finance have yet to grow. A strong and stable institutional framework for development finance in export credit is conspicuous by its absence. The nurturing of these young institutions, encouraging their growth, and the rearing of personnel trained in the field of export finance, therefore, constitute important aspects of the promotional task of a central bank in an underdeveloped country. If the Reserve Bank of India at present does not take the initiative to close the numerous gaps in the machinery of industrial, agricultural, and export finance, they will remain unfilled. It is only when the task of building up the financial infrastructure of the growing economy has been fulfilled that a central bank can retire gracefully, concentrate exclusively on central banking functions proper, and operate as a distinct institution.

In the context of development plans careful husbanding of the scarce foreign exchange resources in the hands of the central banks has assumed added significance. It has, therefore, been thought pertinent to examine the role of the Reserve Bank of India in the mobilisation of foreign exchange and administration of exchange control during the planning era.

XII

With the expansion of both deposit and bank credit under the stimulus of the Five Year Plans and the remarkable diversifications of the bank's activities,

a series of amendments to the Banking Companies Act of 1949 (now the Banking Regulation Act) as well as the Reserve Bank of India Act of 1934 have been effected according to the changing needs of the economy. The new powers conferred on the Reserve Bank of India are intended to strengthen and consolidate the banking structure towards the fulfilment of growth objectives of the planned economy.

The provisions of the Act regarding minimum adequacy of banks' capital funds which were introduced in the pre-Plan period naturally became outmoded in the planned economy. The Act was amended requiring every bank to transfer 20 per cent of its profits to reserves even after it equals the paid up capital. A norm has been set by the Reserve Bank that it may exempt a bank from the provision of this section if the ratio of paid up capital and reserves reaches 6 per cent of the deposits. If this convention is practised in the right spirit, the regulation will improve the tone and efficiency of the banking system by strengthening the capital base of the banks. It is our impression that the capital-assets (realisable value and not balance sheet value of assets) standard which is being increasingly adopted in recent banking legislations is more scientific than the outmoded capital-deposits ratio. The 39 per cent liquidity requirements of the Indian banks is considered to be too drastic when demand for credit is growing under the stimulus of the Plans. In an expanding economy the ability of the banking system to extend credit to *bona fide* requirements of the private sector must not be curtailed. The present liquidity requirement may result in starving and depriving the developing sectors of the much needed bank finance and ultimately stunt the growth of the economy. The time-honoured concept of liquidity loses much of its sanctity in a developing economy in which the solvency of the banking system becomes identical with the economic efficiency and solvency of the Government. The Indian institution has been armed with sweeping powers of control over the banking structure of the country. With additional new powers and responsibilities it will not be able to escape from a direct responsibility for a major banking crisis should it occur in India. In brief, it possesses adequate powers to deal with any emergency. Even the powers of moral suasion have increased considerably in recent years. The planned economy has brought the Indian central bank closer to the commercial banks and the determination to fight the continuous inflationary pressure generated by large-scale Government expenditure is helping to forge valuable ties of cooperation between the two. Such habits of cooperation provide the means of increasing the influence of the central bank over the banking and credit structure of the country.

In the course of this study, the major causes of weakness of the Indian commercial banking structure have been exposed. The steps taken so far by the Reserve Bank to strengthen and consolidate the commercial banking system have been fully examined. The legislative measures adopted so far and directives issued from time to time for regulating the banking behaviour oriented to the growth pattern of the economy have been fully discussed and critically examined to indicate lines of improvement.

XIII

Recently, a fresh concept of bank credit behaviour has been introduced which seems to bestow on the banking system a new consciousness on the application of bank funds to certain economically weak, but socially viable, sectors which have hitherto received less attention from the central monetary authority. The essential idea behind this concept is that banking—including central banking—is a public service, where the social ends are more important than profitability. The public service aspect of banking institutions is no longer in serious dispute. Yet, the practical question often is whether the entire banking system needs to be nationalised. The objective of 'social control' over the commercial banking system as envisaged in India is to ensure, without an actual takeover of banks into public ownership, the achievement of those social ends that nationalisation could conceivably secure. The major objective, clearly, is to effect a more purposeful distribution of available credit in terms of accepted investment priorities and correspondingly a more efficient mobilisation of savings, since the credit needs are always likely to run ahead of the availability of savings.

With the nationalisation of major commercial banks the management of commercial banks has been brought into sharp focus. The concept of management, if properly applied to the banking sphere, would enrich considerably the efforts to make the banking institutions play a more dynamic role in India's economic development programme. If banks are to play a socially oriented role, they must be prepared to infuse some radical thinking in their traditional management concepts and practices so as to be able to meet the challenge of change more vigorously. The social objective calls for a larger allocation of available resources to priority sectors such as agriculture, small industries, and export which are being encouraged as a part of the broader national, economic, and social strategy. The social objective must be translated into reality through the policies and operations of the central bank, as well as the commercial banks, and other financial institutions. The most onerous responsibility, however, devolves upon the Reserve Bank of India as the guardian of the monetary system.

Although the Indian banking system has registered striking advances in recent years, both dimensionally and in terms of functions, there is still a great deal of dissatisfaction with it. Its coverage is limited to the urban and semi-urban areas. Even within the areas it covers, the tendency has been for it to cater mainly to the needs of the relatively bigger and better established industries or businesses. There has been little effort in the direction of reaching out to new classes of entrepreneurs and fostering enterprise along new lines. Bank managements have sometimes been closely associated with certain industrial groups, whose needs have received a measure of precedence thus promoting what has been called a concentration of monopoly power. The principal motivation for change has, therefore, been the desire for more purposive allocation of bank credit in accordance with the Plan priorities. The Banking Regulation Act has been amended in view of this silent revolution in the world of banking and the Reserve Bank

is to have larger powers for a positive direction of credit, to evolve a scheme of priorities, and to take an overall view of the sectoral needs against total availabilities. Meanwhile, a National Credit Council with representatives from industrial, trade and banking interests as well as specialists from priority sectors has been set up to define priorities and to provide guidelines to the banking system.[16] The stress on purposes, and with them on priorities, is as a logical development in the context of a socially determined programme of economic and financial development. One recalls in this context Keynes's[17] highly perceptive observations:

> ...in Great Britain...the amount lent to any individual being governed not solely by the security and the rate of interest offered, but also by reference to the borrower's purposes and his standing with the bank as a valuable or influential client.

The purposive direction of credit that the scheme of 'social control' aims at will, it must be emphasised, evolve over time. It is important to ensure that in the attempt to direct credit into new lines, the old ones are not starved; the exercise would be meaningless if new 'gaps' were to arise in the process of filling up old ones. It is fair to say that banks cannot change their practices overnight, and some of the new tasks that are being envisaged for them are by no means easy ones. It will be necessary for them to build up adequate machinery with the needed expertise to be able to cope with these tasks both at the head offices and in the field. There are, similarly, problems for the central banking authorities as well. There is the overall constraint of resources, and the central bank cannot but weigh carefully its accessibility to the banking system both in terms of the price aspect and the quantity aspect. There are also a number of technical problems that arise in this context. Within the overall framework of credit policy and allocations, there are special needs to be taken care of—needs arising from a seasonal or cyclical situation or from the particular problems of an industry, nationally or regionally. Both adequate information and careful analysis are needed for timely appraisal of the emerging needs and the appropriate response to them.

The sectoral priority for credit allocation, however, is not suggestive of a blind diversion of resources to the indicated channels irrespective of their productivity. The productivity of resources is gauged by the extent of resources generated by any given investment. The resources generated are funds in-flow and all investments are funds out-flow. These in-flows and out-flows have a time dimension. It is the ratio of in-flow of funds to out-flow of funds that measures the productivity of investments. The higher the productivity of investment, the more rapid is the rate of economic development. It, therefore, follows that creative employment of bank credit should be gauged by the extent of fund in-flows they help generate directly or indirectly. In each preferred sector, through

[16] With the imposition of social control over commercial bank behaviour, this Council was set up in 1967. After the nationalisation of major commercial banks and with the functioning of Credit Cell in the Reserve Bank of India this institution has become superfluous and therefore, defunct. Officially, it is still alive. But the academic world is not aware of its existence.

[17] Keynes, J. M., *A Treatise on Money*, Vol. II, 1930, Macmillan & Co. Ltd., London.

periodical field surveys and research studies, the central bank should first assess the potential for creative investment both regionwise and activitywise and determine the ratio of bank credit to fund in-flow generated, in relation to the overall investment or fund out-flows. This ratio may become the target to be achieved or results to be produced.

XIV

The changing role of the Reserve Bank of India in relation to the public and political authorities has been brought into sharp focus in the light of foreign experience. An agreeable consensus is almost impossible to obtain amongst the 'political-economic leviathan'. The central bank was designed to be kept apart from politics but the contemporary monetary policy is influenced by the strongest political considerations and expediency. Possible means have been suggested for preventing unseemly conflicts between the central banker and the political authorities. One interested in central banking policy must be concerned with the identity of the central bank as a political institution as well as what it does in the area of monetary affairs.[18]

The central bank is a part of the apparatus of the Government and within that context, it must find arrangements which permit it to use its powers effectively and without political interference. The meaning of independence of the central bank is not an independence from the Government, it is an independence within the Government.[19] A good deal depends on history and tradition and a fair amount even on the personalities involved. It is obligatory on the part of an alert, conscientious central banker to warn the Government of any condition which may pose a threat to the country's monetary stability. He must, however, confine his advice only to financial and economic issues on which he is qualified to advise by virtue of his technical competence. It is his duty to communicate his views to the political authorities on controversial fiscal problems confidentially, and to inform them to what extent his responsibility to maintain monetary stability is being impaired by the budgetary and taxation policies of the Government, and to advise them as to the degree in which these call for modifications. He must, however, be particular not to 'dabble in matters which might have political implications', and therefore should not take part in a public controversy.

The public should always be entitled to assume that if the Governor were directed to carry out a monetary policy which, in good conscience, he could not regard as being in the national interest, he would, after taking steps to ensure that the issues involved were placed clearly before the public, resign.[20] A central banker can contribute substantially to the Government's discussions on economic policy matters and the Government should associate him with the formulation of

[18] Timberlake, R. H., Jr., *Money, Banking and Central Banking*, Harper & Row, New York (pp. 342–346) and also his letter to the writer dated the June 4, 1969.

[19] The Radcliffe Report, Vol. I, pp. 256, 286 & 295. See footnote 1 (Ch. 2).

[20] *The Per Jacobsson Foundation Lecture*, delivered by Mr. Louis Rasminsky, Governor, Bank of Canada on November 9, 1966, Altieri Palace, Rome.

those decisions on economic policy affecting monetary operations.

Although the ultimate responsibility for overall economic policy rests with the Government, central bankers today emphasise that the due discharge of their duties would call for a certain measure of independence in their technical operations as well as in their policy thinking. The true nature of the relationship between the central bank and the political authorities can be understood neither in terms of 'independence' nor again in terms of 'subordination'. The relationship can best be described in terms of 'partnership'. It is this concept of a 'partnership' in a joint venture, a spirit of close and continuous cooperation which alone can resolve the historic friction.

XV

The objectives underlying the takeover of major commercial banks by the Government were to generate the willingness and the capability of the major banks in the private sector towards a far-reaching approach to the social problems of India and in using their talents and strength to ameliorate social inequalities and to promote balanced development. How far the objectives of planned operations of banks to meet the ends of socio-economic justice have succeeded and how far the neglected and forgotten sectors of the economy have received the enthused attention and the benefits of bank finance have been probed in greater detail.

The spatial spread of banking in general, and its rural reorientation in particular, are the two outstanding features of the post-bank-nationalisation era. Public sector banks have failed to promote the rural segments of society to the desired extent. Besides, wide disparities in the regional spread of banking facilities still predominate particularly in the Eastern Region. The cost structure of the banks and their attitudinal and ethos barriers are formidable obstacles. To take just one example, a peon in a rural branch draws higher emoluments than the village headmaster. Since such odd features reflect serious social stress and strain, making the banks socially unacceptable in the rural areas, the Government has decided to fuse banking with a rural setting to overcome the complex sentiments, prejudices, and suspicions inherent in the situation.

Instead of quantitative studies of branch expansion, decrease of bank population, bank profits, deposit mobilisation, advances including the priority sector advances of regional growths, this investigation purports to focus a few indicators towards the qualitative changes.

XVI

Central banking really is what the central bankers make it. It is, indeed, a complex and delicate operation and as such it cannot be established successfully by means of legislation. It is far better not to limit the discretion of the central bankers by introducing too many details into the statute. It is a product of years of experience and of the growth of sound conventions. While central

banks, under the traditional gold standard, were merely expected to conform to the 'rules of the game', they exist today, to use an expression of Professor Sayers again, 'for the very reason that there are no such rules' any more. Central bankers must seek to meet the various objectives of economic policy by means of the monetary powers at their discretion to the largest extent possible. A succession of very able Governors who manage the operations of these banks will materially increase the significance of central banking. What emerges as the next problem in the underdeveloped countries is the task of finding and training adequate personnel to carry out successfully the functions being undertaken by those central banks. The task of finding an able Governor—a practical central banker as well as a good theorist—and an efficient staff to support him is now going to prove a more important task than the search for any more new gadgets of control.[21] What has been in shortest supply among central bankers is not a working knowledge of how monetary policies work, but imagination and venturesomeness in drawing on knowledge and administering powers we already have. Professor Whittlesey[22] has aptly observed:

> Success depends on the refusal of central bankers to be immobilised from constructive action by inordinate fear of being found wrong. Insufficient attention has been given, certainly in the United States, to discovering both new methods and more effective ways of applying old methods.

The attempts at international financial cooperation have been largely palliative and *ad hoc* arrangements. A more serious, long-term and basic monetary organisation in the form of a world central bank is conceivable and has had some recent support. The requirements for such a system would be technically simple yet politically formidable. A world central bank would require each participating country to hand over its fundamental monetary sovereignty to this institution. No national governments, particularly strong ones, are ever willing to give up sovereignty over an item as important as the stock of money—particularly to an international agency which might be operated by representatives of countries whose 'political-economic' ideas and ideals were not particularly palatable.[23] The overwhelming improbability of getting an agreeable consensus amongst the politicians and the economists so that the agency would run itself is thus manifest. Even so, attempts might be made.

The institutional setup in the field of finance, as in any other field, has to be in response to the particular situation that exists at any given time, the degree and pattern of prior development, the availability of resources of finance as well as of manpower, and the mores currently acceptable to the community. There can be no universal recipe, no set pattern that others can take over and plant in their own environment. The Indian pattern will evolve in time, and the

[21] Sen, S. N., *Central Banking in Undeveloped Money Markets*, Bookland Pvt. Ltd., Calcutta, 1961, pp. 273–274.

[22] Whittlesey and Wilson (Ed.), *Essays in Money and Banking in Honour of R. S. Sayers*, Clarendon Press, Oxford, 1968, pp. 264–65.

[23] Timberlake, R. H., Jr., op cit., pp. 293-296. A discussion of this possibility by Robert Triffin appears in *Money and Economic Activity, Readings in Money and Banking*, Lawrence S. Ritter (Ed.), Houghton Mifflin, Boston, 1961, pp. 435–445.

precise relationships between the Reserve Bank and other financing institutions that will ultimately crystallise cannot be predicted at the present stage. No last word can be said about the stimulating activities of central banking to promote the growth of the national economy as the processes are of continuous innovations and the matter is never free from controversy.

This work, therefore, aims at observing and analysing the central banking operations in India in the context of the planned development programme of the country and the lines along which reorientation needs to be made to guide the banking and financial system to cater to the growth objectives. The pattern of central banking behaviour in India has undoubtedly shown a refreshing change lately. This unmistakably indicates a reoriented and wholesome outlook for providing stimulus to the transformation of the national economy in India along the desired direction. It is not possible to make serious prognostication at this stage as to what the ultimate phase of a central bank's growth-oriented role will be. All one can say is that the Indian experience in regard to the developmental role of the central bank has been meaningful in the given context and one should not, in assessing its further potentialities, be prejudiced by the patterns of central bank attitudes and practices that have evolved in the more developed world. An essential characteristic of satisfactory central banking policy must be adjustability and flexibility of action.[24] Not more conservatism but more resourcefulness and more flexibility will, hopefully, provide the answers to the problems of the developing countries.

The evolution of central banking is far from complete and, indeed, is still in a state of flux and formation. In India today, it has yet to reach a settled and final status. The rumblings of revolutionary changes have been heard before and could be heard again.[25]

[24] Prof. Chandler is convinced on this point and has an excellent analysis in *Central Banking and Economic Development*, pp. 26–28.

[25] Fourteen major Indian Banks were suddenly nationalised at midnight of July 19, 1969. The Banking Commission suggested certain basic changes in the restructuring of the banking system. The Government has, moreover, decided to set up a special category of 'Regional Rural Banks' to fuse banking with the rural setting (See Chapter 13, Section II). Another Banking Commission has been set up in July 1976, mainly to restructure the public sector banks.

2

The Role of Monetary Policy in the Planned Economy of India

Trends in Monetary Management in the Pre-Plan Period

The first chapter of the Radcliffe Committee's Report[1] opens with the following interesting observations on monetary policy:

> Monetary policy is necessarily moulded by the world in which it takes shape. The scope for its exercise is not invariable, and the aims....and the techniques which give it effect are all conditioned by the facts of the economic situation and the ideas of the time.

Monetary policy is, thus, not an independent entity but a part of the overall economic policy of a country. In relation to economic growth monetary policy should be designed to help the process of development by adjusting money supply to the requirements of growth, by directing the flow of funds into desirable fields of investment, and by providing institutional facilities for credit in specific sectors of economic activities. Analysis of the monetary policy of a country reveals the fact that the objective of monetary policy has changed from time to time according to exigencies of circumstances.

After World War II, most of the war-torn countries tried to rehabilitate their economy by regulating their monetary policy whereby greater emphasis was laid on the need of a high level of investment to accelerate the pace of economic growth. For example, the British Government specially stressed 'steady economic growth and improvement of the standard of living' as one of the major objectives of monetary policy during the postwar years.[2]

Economic growth as an objective of central banking policy represents the same significant step in the development of monetary policy in the postwar years as full-employment had been in the central banking legislations of the prewar decade. In sharp contrast with the central banking statutes in the prewar days adequate economic growth or development as a notable aim of monetary policy

[1] *Report of the Committee on the Working of the Monetary System*, Her Majesty's Stationery Office, London, 1959. Lord Radcliffe (Chairman). Referred to hereafter as the Radcliffe Report.

[2] The Radcliffe Committee Report, para. 69, p. 22.

has been assigned top priority in the Acts of central banks recently set up in underdeveloped countries. The effort of central banking to stimulate economy in the postwar period can be traced in the statutes of the central banks of Paraguay, Guatemala, the Dominican Republic, the Philippines, Ceylon,[3] Malay,[3a] Burma, Pakistan, Ghana, Nigeria, and of the Federal Reserve System. It is interesting to note that there are such expressions as 'orderly economic growth', 'growth of the country', and 'steady development of the nation's resources' in a publication of the Board of the Governors of the Federal Reserve System.[4]

The Reserve Bank of India, the central monetary authority of India, functioned with restricted scope till the end of World War II and the monetary policy of the Reserve Bank of India during the war was essentially concerned with the management of the deficits incurred to finance it. The techniques of monetary policy pursued by the Reserve Bank of India during the war have been characterised by Professor K. N. Raj[5] as a

> conglomeration of measures adopted at each step with respect to the immediate requirements, created by war whose future demands were of an unknown magnitude, and particularly under the peculiar conditions obtaining in India.

With the attainment of independence in August 1947, dawned a new era in India heralding a new phase of economic development. The National Government began to forge ahead with a positive outlook in the economic domain and the policy of the State's active participation in various economic activities began to take shape. The war-time policy of mobilising resources to meet defence needs was changed to one which would finance the development plans in postwar India and the transformation followed.

It was thought necessary to arm the Reserve Bank with direct powers for managing the war-shaken national economy. The Bank was brought under public ownership and management by the Reserve Bank (Transfer to Public Ownership) Act, 1948. The Banking Regulation Act, 1949[6] was passed giving the Bank wide and overriding powers of supervision and control over the banking system with a view to strengthening the institutional frame of the money market and making the policy of selective credit control more effective in channelising credits to socially desirable fields in the context of the objectives of the development Plans. The Reserve Bank of India thus emerged as a conscious guardian and watchdog of the monetary structure of the country in the postwar economy of independent India. Briefly speaking, the scope of monetary policy was widened enough to influence the monetary-credit structure with greater effectiveness and to make adequate adjustment to meet the needs of economic growth envisaged in the Five Year Plans.

[3,3a] At present Sri Lanka and Malaysia respectively.

[4] *The Federal Reserve System, Its Purposes and Functions,* ed. 1954.

[5] Raj, K. N., *The Monetary Policy of the Reserve Bank of India,* National Information and Publications Ltd., Bombay, Popular Prakashan, 1948, p. 160.

[6] Formerly the Banking Companies Act, 1949.

II

The Working of Monetary Controls vis-á-vis the Position of Scheduled Banks during the First Plan Period

The significance of a sound monetary policy was rightly emphasised by the Government of India in its First Five Year Plan.[7] Central banking in a planned economy had to take on an active role in increasing developmental activities and ensuring that finance flows to the fields envisaged. This objective of monetary policy continued throughout the planning era and steps were taken to encourage savings, provide incentives to investment, prepare a climate conducive to the attainment of Plan programmes by arresting inhibitory factors and curbing inflationary spirals. The acceleration of economic development 'in an environment of reasonable price stability' was the watchword of the monetary policy.

With the beginning of planned economy the Reserve Bank of India launched a new approach to monetary policy and raised the bank rate from 3 to 3.5 per cent to coincide with the beginning of the busy season in November, 1951, after 16 years of stability. It was raised to counteract the postwar trend of rising prices and the inflationary pressures generated by the Korean boom. This was a signal to the banking system initiating a policy of tightening credit and it virtually put an end to the era of cheap money policy. This step was needed to control inflation and, at the same time, to gear credit to the genuine needs of trade and industry of the First Five Year Plan. The justification for a new policy, it is claimed, was found in the big rise in bank credit during the busy season of 1950-51. With the launching of the new monetary policy the Reserve Bank could again control credit and the volume of money supply. The motive was that the market would be getting as much money as the Reserve Bank chose and not as much as the market wanted.

It might not be out of place to mention here that there is a great deal of controversy in Western countries about the efficacy of bank rate—even an expert body like the Radcliffe Committee has spoken equivocally about it.[8] In a poorly monetised underdeveloped economy, the effectiveness of the bank rate is, of course, limited, as a considerable portion of credit flows into the system from outside the monetised sector. Therefore, what seems to be necessary is a 'package deal' approach in which the monetary mechanism is supplemented and supported by, and fully coordinated with, fiscal policies and physical control measures.

Simultaneously with the raising of the bank rate a suitable change was effected in the technique of open market operations. The Reserve Bank of India declared that thenceforth it would not freely purchase Government securities in the open market but that it would grant advances to scheduled banks[9]

[7] *First Five Year Plan*, loc. cit., p. 38.

[8] The Radcliffe Committee Report, p. 162.

[9] In Indian terminology, banks are divided into two classes—scheduled and nonscheduled banks. Scheduled banks have a paid up capital and reserves of Rs 500,000 or more and are included in the Second Schedule of the Reserve Bank of India Act, 1934. In this study the term

against Government and other approved securities specified in Section 17(4)(a) of the Reserve Bank of India Act, 1934. In other words, banks were not to be refused reserves, but the method of providing them had been changed.[10]

Hitherto, the normal practice of the Reserve Bank was to buy Government securities offered to it for sale at market rates. As a result, scheduled banks were able to obtain funds during the busy season by selling Government securities in their portfolio to the Bank and thereby augmenting money supply freely in the midst of inflationary pressures.

Since this change in the open market policy of the Reserve Bank, its operations have grown to be more flexible and significant. The immediate effects of the change in the bank rate and the open market policy were a hardening of the structure of interest rates and a stoppage of the automatic expansion of liquidity in the system through the Reserve Bank's purchases in the open market. The shift in policy further enabled the Reserve Bank to influence the pattern of bank advances. Since banks had to resort to borrowing from the Reserve Bank to meet their seasonal demands, they had to exercise greater caution in their lending operations.[11]

Stated differently, the new monetary action imposed an effective check on the expansion of money supply during the busy season and the pattern of interest rates also adjusted to the situation.[12] These adjustments curbed speculative lending and enabled the Reserve Bank to exercise an effective control on the magnitude and purpose of bank advances. The contraction in the volume of credit limited the scope of speculative trading which, in its turn, had an impact on the downward trend in prices. The Reserve Bank thus acquired a greater measure of control than it ever had on the banking system.

As stated above, the bank rate by itself is not a powerful instrument of policy because it forms only a small segment of the whole interest structure which regulates the flow of funds to different sectors and uses. Its significance in India is further limited by the fact that it relates only to the borrowings of scheduled banks from the Reserve Bank. These are not large and even at the peak of the busy season have been till today only about 10 per cent of the total bank credit. Evidently, the rise in the bank rate would not by itself have had the effect of increasing the degree of control by the Reserve Bank over the supply of money and credit in the system, had the Reserve Bank continued to buy Government securities in the open market as readily as it had done hitherto. It was, therefore, inevitable that the bank rate policy should have been supplemented

'scheduled bank' refers to *scheduled commercial banks* excluding the 14 State cooperative banks included since 2nd July, 1966 in the Second Schedule to the R.B.I. Act, 1934.

[10] Olakanpo, J. Obasanmi, *Central Banking in the Commonwealth*, 1st Edn., Book Land Pvt. Ltd., Calcutta, 1965, p. 102.

[11] For details see *Report of the Central Board of Directors*, Reserve Bank of India, 1952, pp. 15–16, & 19, and also the Report for 1954.

[12] The Imperial Bank (State Bank) raised the general lending rate from 4 to 4.5 per cent, the call rate for advances to banks against Government securities of Rs 5 lakhs and above from 2.75 to 3 per cent and for amounts less than Rs 5 lakhs from 3 to 3.25 per cent and again rate of advances of Rs 5 lakhs and above was raised to 3.5 per cent.

by an adjustment of the Reserve Bank's open market policy, so as to prevent the monetisation of public debt by banks.

It is profitable to remember that for achieving a higher rate of growth, it is necessary to have not only an adequate amount of investable funds but also a proper distribution of these funds amongst competing uses. And to ensure that the flow of funds to the different segments is in accordance with the Plan objectives, this sphere of regulation has necessarily to encompass the complete structure of interest rates or the liquidity of the whole economy.

A point of paramount importance to be noted in the monetary policy in the pre-Plan period was its failure to create an organised discount market. The development in the use of bills did not make any progress during the decade 1940–50. Even after one decade and a half of the Reserve Bank of India's patronage, the bill market seemed to be as far from realisation as ever.

A development of great significance in the Plan period was that the Reserve Bank introduced under the provision of Section 17(4)(c) of the Reserve Bank of India Act, 1934, the Bill Market Scheme, effective from January 16, 1952. The Reserve Bank announced that it would "make advances to scheduled banks in the form of demand loans, against their promissory notes, supported by usance bills or promissory notes of their constituents".

The banks were accorded a further inducement by way of facilities for accommodation against usance bills at .5 per cent below bank rate, i.e., at 3 per cent. This scheme enabled the commercial banks to draw upon the Reserve Bank for extra funds during the busy season by converting some of their loans into bills. Before the scheme was launched, the commercial banks could borrow from the Reserve Bank mainly on the basis of Government securities, that is by surrendering some of its holdings of Government securities. It was conceived that some relief should be provided to the banking system from the rigours of the new monetary policy. Thus, the Reserve Bank had to come to the aid of the market to moderate or arrest the progressively declining price level in the months following April 1951, as indicated in Table 2.1.

The scheme successfully helped in mitigating seasonal stringency in 1952–53. Initially, the scheme was restricted to the scheduled banks having deposits of

TABLE 2.1. Index Numbers of Wholesale Prices in India, USA and UK, 1951-52
US Base: January-June 1960=100

	India	*USA*	*UK*
1951 2nd Quarter	116	117	129
1951 3rd Quarter	113	116	130
1951 4th Quarter	112	116	133
1952 1st Quarter	104	114	134

Sources: i) *Report on Currency and Finance*, Reserve Bank of India, 1951–52, Statement 16.
ii) International Financial Statistics issued by the International Monetary Fund, 1952. (The prices in India fell by 17.5 per cent as against 2.7 per cent in the USA and a rise of 4.8 per cent in the UK.)

Rs 10 crores or above.[13] The scheme was extended in June 1953 to the scheduled banks having deposits of Rs 5 crores or above; in July 1954, the scheme covered all scheduled banks possessing a licence under Section 22 of the Banking Regulation Act, 1949. In order to enable the smaller banks to make use of its facilities the minimum amount that could be borrowed at any one time and the minimum amount of the bill were also reduced from Rs 25 lakhs and Rs 1 lakh to Rs 5 lakhs and Rs 50,000, respectively. The Reserve Bank observed that in 1953–54 "movements in money supply during the year were in accordance with the growing requirements of a developing economy".[14]

The Bill Market Scheme also added considerable flexibility to the functioning of the Reserve Bank as lender of last resort. Tables 2.2 and 2.3 show the amount of advances availed of thereunder during the last 17 years, classified according to the Five Year Plans.

TABLE 2.2. Gross Advances (i.e. Exclusive of Repayments) made by the Reserve Bank, 1951–1960

(In crores of rupees)

Last Friday of	*Under Section* 17(4)(*a*) *(against Govt. securities)*	*Under Section* 17(4)(*c*) *(against bills under the scheme)*	*Total advances*
The First Plan Period			
1951	76.57	—	76.57
1952	164.25(66.8)	81.45(33.2)	245.70
1953	129.58(66.3)	65.84(33.7)	195.42
1954	188.70(56.2)	147.52(43.8)	336.21
1955	199.94(47.06)	225.44(52.94)	425.38
The Second Plan Period			
1956	466.95(51.66)	436.82(48.34)	903.77
1957	353.78(46.1)	414.81(53.9)	768.59
1958	237.57(60.8)	153.06(39.2)	390.63
1959	518.20(86.1)	83.32(13.9)	601.52
1960	502.06(85.4)	85.41(14.6)	587.47

(Figures in the brackets indicate the percentage of total advances)

Sources: *Reserve Bank of India Bulletins*, various issues; *Commerce*, Bombay, January 26, 1957 and *Trend and Progress of Banking in India*, Reserve Bank of India, 1960.

It is evident that the scheme's popularity went on increasing. It also indicates a shift from erstwhile borrowing of the banking system against Government securities to that against bills and their respective amounts. The fall in 1953 may be due to overall stability in the economy during 1953 and a quiet year for the banks. Again during 1958 and 1959, there was a perceptible fall partly owing

[13] For details see *Report on Currency and Finance*, Reserve Bank of India, Bombay, 1951–52, pp. 55–56.

[14] Ibid, 1953–54, p. 28.

TABLE 2.3. Advances of the Reserve Bank of India to Scheduled Banks under Section 17(4)(c), 1960-61–1966-67

In crores of rupees

Year	*Advances*	*Total Advances*
1960-61	255.29	1073.57
The Third Plan Period		
1961-62	284.79	643.16
1962-63	325.70	663.55
1963-64	253.99	741.38
1964-65	274.75	1065.34
1965-66	323.31	1251.99
Period after the Third Plan		
1966-67	418.16	1100.09

Source: *Reserve Bank of India Bulletin*, March 1967, p. 378. Advances under Section 17(2)(a) and 17(4)(b) are nil. Advances under Section 18(1)(3) are Rs 77 in 1960.

to an increase in the cost but mainly due to an increase in their deposits and a consequent fall in their requirements. This marked fall in advances by the Reserve Bank under the scheme in these two years was in conformity with the reduction in total advances by the Reserve Bank to scheduled banks. However, with stringent monetary conditions since 1960–61, the amount of bills gradually increased. This rising trend of borrowings under 'the Scheme' is significantly helpful for the Reserve Bank to exercise a qualitative check on bank credit expansion during the busy season. The Committee on Finance for the Private Sector expressed satisfaction over the Bill Market Scheme in the following terms: "The scheme has been a very welcome addition to the money market of the country and has been of substantial help to the commercial banks."[15] The scheme also helped the Reserve Bank to ensure that such advances were for *bonafide* trade purposes and for short periods. With the extension of the Bill Market Scheme by stages, the number of eligible banks nearly doubled to 51 by May, 1959.

For the purpose of export promotion, the Reserve Bank further introduced the Export Bills Credit Scheme in March 1963, which was within the purview of the Bill Market Scheme, for the purpose of providing larger credit at reasonable rates to Indian exporters (see Chapter 10) and the Reserve Bank of India Act, 1934 was suitably amended in 1962 and 1963. The introduction of this scheme has widened the range of the collateral for borrowing from the Reserve Bank as banks can borrow against usance export bills at a lower cost and stamp duty charges of 0.2 per cent need not be paid.

In view of the soaring price trend since the middle of 1955 and a large expansion of bank credit in the busy season of 1955–56, the Reserve Bank no longer

[15] *The Shroff Committee Report*, pp. 56–57.

considered it necessary to allow concessions and raised its lending rates under the Bill Market Scheme.[16] Benefit of reimbursement of a portion of stamp duty was also withdrawn.

The scheme has achieved success only in the organised sector whereas a fairly large nonmonetised sector remains outside the control of the Reserve Bank of India. About 35 per cent[17] of the total national income is still outside the purview of monetary transaction. The Reserve Bank failed to extend the scheme to the indigenous sector which still controls about 50 per cent of the financing in the market. In order to meet the developmental needs of planning the scheme should be extended to provide rediscount facilities to the unorganised sector also.

Following the introduction of the Bills Rediscounting Scheme under Section 17(2)(a) of the Reserve Bank of India Act with effect from November 1, 1970, it was decided in November 1971 that the Bill Market Scheme introduced in 1952 under Section 17(4)(c) of the Act should be discontinued except for the limited purpose of providing refinance in respect of finance made available by banks for food procurement operations and defence packing-cum-supply credit. Under the old Bill Market Scheme, the Reserve Bank provided refinance to banks against usance bills which were specifically created by converting cash credit accounts of borrowers. They were not negotiable or marketable instruments and remained with the Reserve Bank of India with the result that the Reserve Bank was constrained to become the *lender of the first resort.*

The bills to be rediscounted by the Reserve Bank under the new scheme will be negotiable and marketable and their negotiability is an essential condition for the development of a sound bill market. They will impart flexibility to the money market, help to even out surplus and deficits in the banking system and will enable the Reserve Bank to exercise effective control over the money market, as recourse to Reserve Bank will normally be only when the banking system as a whole is short of funds, rather than only when a few banks are in need of funds. Thus the Reserve Bank will become *the lender of the last resort instead of the first resort.* Expansion and contraction of money by the Reserve Bank as a result of the rediscount of such bills will become related directly to the needs of the economy. It is expected that the scheme will enable the banking system to augment its resources adequately to meet the emerging needs of trade and industry during the busy season.

[16]

Bank Rate	*Rate of Interest under Bill Market Scheme*	*Period*
%	%	
3.5	3	Jan. 16, 1952 to Feb. 29, 1956
3.5	3.25	Mar. 1, 1956 to Nov. 20, 1956
3.5	3.5	Nov. 21, 1956 to May 15, 1957
4	4	May 16, 1957 to Jan. 2, 1963
4.5	4.5	Jan. 3, 1963 to....

(The rate of interest charged was thus in conformity with the bank rate from November 21, 1956.)

[17] Iengar, H. V. R., *Monetary Policy and Economic Growth,* Vora & Co., Bombay, 1962, p. 136.

A measure of the increasing extent to which banks are availing of the new scheme is evident from the fact that despite the comfortable liquidity position, bills rediscounted with the Reserve Bank in the 1971–72 busy season amounted to Rs 45 crores at the peak level on March 17, 1972, as against Rs 14.1 crores on April 30, 1971, at the peak level in the 1970–71 busy season. As banks get better geared to lending against bills wherever possible rather than book debts and inventories, this scheme should become an important means of rediscounting by the Reserve Bank of India.

An important feature of busy season credit expansion in 1973–74 was a record increase of Rs 244 crores in bills rediscounted by the banks with the Reserve Bank as against Rs 19 crores in the previous busy season. The principal object of the new Bill Market Scheme is to bring about the popular use of the bills of exchange as an instrument of credit in substitution of the existing arrangement of credit extended against inventories and receivables. While the volume of bills rediscounted continued to be quite large throughout the year 1973–74, the scrutiny of the bills adequately established that they were genuine ones and maintained their self-liquidating character.

As a result of the policy of credit restraint and higher costs of rediscounting, bills rediscounted with the Reserve Bank recorded a decline in 1974–75. The amount outstanding as on June 27, 1975, at Rs 132 crores showed a decrease of Rs 142 crores over the level at the end of June 1974 as against an increase of Rs 259 crores during the corresponding period of the previous year. Previously, there was no genuine Bill, there was no market; hence it was not a Scheme at all. The consolidated picture of the assistance provided by the Reserve Bank of India to scheduled commercial banks under Section 17(2)(a) against bills rediscounted i.e., new Bill Market Scheme under Section 17(4)(a) against Government securities and under Section 17(4)(c) in the old Bill Market Scheme is given in Table 2.3A.

TABLE 2.3A. Assistance Provided by the Reserve Bank of India to Scheduled Commercial Banks, Fourth Plan Period

(In lakhs of rupees)

Year	*Total*		*Bills Rediscounted*		*Advances*			
			Section 17(2)(*a*)		*Section* 17(4)(*a*)		*Section* 17(4)(*c*)	
	Assistance	*Outstandings*	*Amount*	*Outstandings*	*Advances*	*Outstandings*	*Advances*	*Outstandings*
	1	2	3	4	5	6	7	8
1969-70	277,692	23,794			128,876	8,158	111,059	7,781
1970-71	479,502	33,627			179,671	3,733	171,969	19.016
1971-72	413,688	24,894	14,902*	4,149	111,084	4,302	119,422	9,842
1972-73	207,578	19,888	17,467	3,611	102,896	7,172	22,059	3,061
1973-74	407,941	67,822	69,427	25,511	166,597	7,522	31,082	3,675
1974-75	589,592	72,401	158,824	18,607	60,427	5,399	84,298	21,786

* Relates to the period July 1971 to March 1972 only.

Source: *Reserve Bank of India Bulletin*, July 1975.

III

An Era of Controlled Expansion

The launching of the Second Five Year Plan increased stresses and strains in the economy and monetary policy was used more intensively and extensively during this Plan to meet the situation. Monetary and credit policy of the Reserve Bank has been guided by the twin considerations of assisting a developing economy and combating the growth of inflationary pressures. With a view to fostering an orderly economic growth in the country the Reserve Bank of India Act was amended in 1956 in order to adapt the financial framework to the requirements of economic development under the Second Five Year Plan. The Reserve Bank's policy during the period may be described broadly as one of 'controlled expansion', a synonym for the term 'development with stability' used by the International Monetary Fund Mission which visited India in 1953. While the need for expansion of credit and money supply commensurate with the rapid development and diversification of the economy is fully recognised by the Reserve Bank, an excessive expansion of money supply would be inflationary and would ultimately jeopardise the financial stability of the economy. In the prevailing situation, which has considerable inflationary potential, the direction of credit policy should be one of general restraint without jeopardy to the functioning and progress of essential productive sectors of the economy.[18]

The Amendment of the Reserve Bank of India Act, 1934 in 1956, contemplates on the one hand the flexibility needed in note issues and, on the other hand, empowers the Reserve Bank to deal with the consequences of deficit financing by restraining the power of uncontrolled credit expansion of the commercial banks. The Proportional Reserve System was a legal bar to the expansion of the supply of currency. Accordingly, the Amendment Act of 1956 empowered the Reserve Bank to create currency against a minimum reserve of Rs 115 crores in gold and Rs 400 crores in foreign securities. The latter was reducible, under compelling circumstances, to Rs 300 crores. Moreover, with a view to achieving this objective of the gold reserve of Rs 115 crores, the Amendment Act made provision for the revaluation of the Reserve Bank's gold and currency reserve at 2.88 grains of fine gold per rupee (or Rs 62-8 as—0 p. per tola) instead of 8.47512 grains per rupee (or Rs 21-3 as—10 p. per tola.) The effect of this revaluation was that the value of the gold held by the Reserve Bank jumped from Rs 40 crores to a little over Rs 115 crores. In view of the continously deteriorating foreign exchange situation the Reserve Bank of India Act was further amended overnight on October 31, 1957, for introducing a drastic cut in the foreign currency reserve. Under the new Act, the overall minimum reserve to be maintained by the Bank to back the currency stands at Rs 200 crores of which "not less than Rs 115 crores" must be in gold coins and bullion. These measures imparted elasticity to the currency and credit needs of the economy.

The American monetary authorities faced a similar problem in the earlier

[18] *Report of the Central Board of Directors*, Reserve Bank of India, 1956–57, p. 14.

years of World War II—a declining Federal Reserve ratio. They reduced the ratio by a drastic cut from 40 to 25 per cent. The Indian monetary authorities, however, were evidently not in favour of a rigid link of note issue with central bank reserves. The Indian method was, therefore, endowed with a high degree of flexibility to meet the requirements of expanded note issue in the Plans.

The note-issue system was, however, defective in the sense that it did not make any provision to correlate the reserves to the country's balance of payments. The provision of issue of additional notes without requiring additional reserves of gold or foreign exchange has, in our opinion, opened up the possibility of unbridled inflationary forces. There are certain non-legal limits to currency expansion which cannot be transgressed with impunity. It has to be remembered that inflated purchasing power through injection of money into the market must always be matched by the adequate flow of the supply of output. There should have been a provision in the Amendment Act by virtue of which the Indian monetary authorities could be alerted whenever there was any expansion of circulating media without a corresponding increase in goods and services. Such warning signals are to be witnessed in the central banking laws of the Philippines, Paraguay, and the Dominican Republic.

During the period of developmental planning, when enormous investments are being undertaken, it is desirable that the Reserve Bank of India should keep a careful and continuous watch over the forces germane in growth which may threaten to produce undersirable instability in prices. Under the impact of successive doses of deficit financing and also as a result of the rising volume of Plan outlay, there was a sharp increase in the demand for bank credit. This is evident in Table 2.4.

TABLE 2.4. Demand for Bank Credit, 1951-52–1960-61

(In crores of rupees)

Last Friday	*Demand for Bank Credit*
The First Plan Period	(approx.)
1951-52	546.40
1955-56	632.45
The Second Plan Period	
1956-57	781.65
1957-58	903.00
1958-59	983.00
1959-60	1,124.00
1960-61	1,319.00

Sources: *Reports of the Central Board of Directors*, Reserve Bank of India, 1956–60 & *Reserve Bank of India Bulletin*, March 1967, p. 366.

It was, therefore, considered essential to arm the Reserve Bank with powers to fight the inflationary expansion of bank credit by the Variable Reserve Ratio method. This technique of credit control was used in America for keeping the economy on an even keel during the process of economic growth. Among the

economists Lord Keynes[19] has been mainly responsible for popularising the notion by proposing the introduction of this feature into the ideal central banking system of the future. He urged that some such power, though revolutionary, should be given to the central banks. A similar technique was recommended by the Macmillan Committee[20] for use by the Bank of England.

The importance of Variable Reserve Ratio as a method of credit control increases with the growth of bank money in relation to currency in circulation. A noticeable feature in the growth of money supply during the Second Plan period was the remarkable expansion in the deposit-money component of money supply. With the progress of the Second Plan, the nonmonetised sector was expected to decrease and the scope of the organised banking sector was considered likely to expand with the opening of banking facilities in new areas. So far as the increased money circulation found its way into the banking system the latter's credit creating capacity would increase. To mop up this surplus fund and curb the extra credit creating capacity of the banking system, the Variable Reserve Ratio method was adopted by the Reserve Bank of India.

In October 1956 under the Amendment Act (Section 42), the Reserve Bank was vested with the authority to change the reserve ratio of scheduled banks from 5 to 20 per cent in respect of demand deposits and from 2 to 8 per cent in respect of time deposits.[21] As a result of the continuous upswing of the price index the need of a credit squeeze was felt and the Reserve Bank issued a directive in March 1960, under which all scheduled banks were required to maintain with the Reserve Bank 25 per cent of additional average daily reserves accruing after March 11, 1960, and after May 6, 1960, the percentage was raised to 50 of any addition to their deposits.

In this connection a few words are necessary. It is criticised that there is no provision of forewarning in the Act of the Reserve Bank's decision to raise the reserve ratio. This provision seems necessary in order to allay the apprehensions of the small banks. The central banking laws of the Philippines, Sri Lanka, Guatemala, Nigeria, Cuba, and Malaysia have corresponding provisions. It is clearly demonstrated in those legislations that reserve requirements will be raised gradually by stages and not abruptly without notice.

The provision to notify commercial banks reasonably in advance of the date on which the increased percentages are to become effective is also found in the Rhodesian Bank (Art. 22(3)) and the Korean Bank (Art. 62). In Libya, except in emergencies, a notice of at least 15 days has to be given before directing a change in the ratio, and the percentage has to be varied in a gradual manner. The empowering of the authority to change reserve ratios in varying degrees in different money markets adds a great deal of significance to the weapon but there was no provision to arm the Reserve Bank with such powers. The absence of these provisions in the central banking legislation in India is rather remarkable and is a departure from current trends.

[19] Keynes, J. M., *A Treatise on Money*, Vol. II, pp. 76–77, and 206–261.

[20] *Report of the Macmillan Committee*, para. 360.

[21] Since 1962, scheduled banks are required to maintain 3 per cent of total demand and time liabilities (now 4 per cent).

In our opinion an attempt should have been made to arm the Reserve Bank with powers to fix discriminatory ratios of reserve requirements in the different money markets of Bombay, Calcutta and Madras, and this type of flexibility in the law relating to reserve ratio can be an effective weapon to meet the situation of localised reserve stringency, or superfluity.

According to Aschheim[22] there is an 'asymmetry' between restrictive open market operations and raising of reserve requirements as well as between expansionary open market operations and reduction of reserve requirements, though the asymmetry may not be equally pronounced in all cases. Under conditions of commercial banks being fully loaned up and persistent excess demand for credit, the application of the variable reserve ratio would be likely to cause a switch from Government securities into advances much greater than open market operations. It is the 'income effect' and 'liquidity effect' of the enforcement of higher reserve ratios which cooperate to neutralise the restrictive impact on the banks and induce them to sell securities and increase their loans much more than in response to open market operations. At the other extreme, in the absence of excess reserves and a persistent demand for bank credit the variable reserve ratio may also induce the banks to shift away from Government securities in favour of private loans much more than under open market operations, though not to the same extent as in the former case.

The instrument of the variable reserve ratio, or its variant changing liquidity ratios, has been sought to be introduced into the armoury of central banks in the underdeveloped countries with the object of circumventing the limitations of an open market policy arising from the absence of a broad and active capital market. Generally, there is a good *prima facie* case for using the weapon of the variable reserve ratio in some form or other in underdeveloped money and capital markets, but much depends upon the reserve ratio policy of the commercial banks and the frequency with which changes in reserve requirements may be called for. In a system where minimum reserve ratios are frequently altered the banks may attempt to foil the effects of central banking policy by anticipating the changes and maintaining round-the-year reserve balances much in excess of the statutory minimum. Thus, the employment of the weapon has to be restricted to dealing with crisis or near crisis conditions in the money market.

The solution lies in applying the variation in the cash reserve ratio to future increases of deposits, and not to the total deposits at any one time. The variable reserve ratio may be employed in this form in India to avoid discrimination between commercial banks themselves who might possess different amounts of excess reserves. It would cause no hardship to commercial banks in a less liquid position; at the same time, no advantage will be provided to those commercial banks who might be enjoying a relatively higher degree of liquidity.

A brief reference to the growth of the Nonbanking financial intermediary (NFI) will not be out of place here. The application of this instrument to commercial banks only, since it has been kept outside the purview of central banking

[22] Aschheim, J., *Techniques of Monetary Control*, Johns Hopkins Press, Baltimore, 1961, p. 42. Also Article in the *Economic Journal*, December, 1959.

policy, has been seriously criticised as being discriminatory against the former. The Radcliffe Committee has referred to this aspect of the situation. The NFI may frustrate the objectives of the contractionist effect of reserve ratio by injecting additional resources into the community. The Committee observed that ordinarily drastic alterations of cash or liquidity ratios in the case of commercial banks would not be justified unless general restrictions were imposed simultaneously on the other groups of Financial Intermediaries.[23]

The restrictive credit policy pursued by the Indian monetary authorities was, however, effective to some extent in reducing the excess liquidity of banks; excess cash balances declined and the buildup of Government securities portfolio also declined.[24] But the measure had a limited impact on bank credit because larger borrowings were resorted to by banks from the Reserve Bank than in the previous years. To meet the situation the Reserve Bank had to pursue a more restrictive credit policy and introduced the system of progressive penalty rates on borrowings from it. This action was a direct restriction on the availability of credit from the ultimate lender, the Reserve Bank, and a curb on the tendency of excess borrowing by the banking system.

It was rightly realised that the problem of credit control in India was not only to regulate the total quantity or cost of credit but also to prevent its overflow in particular directions. In a rising market it becomes profitable for producers and traders to hold on to their stocks of essential goods, and if bank funds are made freely available to them for carrying such stocks, hoarding and profiteering are encouraged resulting in further aggravation of the inflationary forces. In such circumstances, the central bank has to be vigilant that bank finance does not flow freely to the market for the speculative holding of stocks, while taking the utmost care to see that the genuine needs of development are not ignored. Therefore, the Reserve Bank of India was called upon to evolve a growth-oriented monetary policy tuned to the twin objectives of holding the forces of inflation in check and of promoting the process of growth. Such a policy was reflected in the adoption of selective credit control measures by the Reserve Bank.

The keynote of credit policy during the Second Plan period continued to be one of general restraint with special emphasis on particular sectors needing financial stimulation and encouragement in a developing economy. In a growing economy new areas of sensitiveness appear and new instruments of central banking control have to be employed to touch and control them. The tightening of general credit controls may, indeed, fail to reach the particular sensitive points and may produce repercussions in sectors where there is hardly any need of treatment. Before administering therapy to all parts of the 'body economic' the particular ailing part should be selected for the administration of 'local therapy'. The weapon was used mainly for preventing bank financed speculative hoarding of food articles through the raising of margin requirements. Section 21(2) of the Banking Regulation Act, 1949 (which is similar to Section 27(1) and

[23] The Radcliffe Report, p. 181.
[24] Iengar H. V. R., op. cit., p. 197.

(2) of the Australian Banking Act, 1945) empowered the Reserve Bank of India to give direction to the banking companies as to the purpose for which advances might or might not be made, and the margins to be maintained in respect of secured advances, etc. This selective control measure as employed by the Reserve Bank of India took the form of regulation of margin requirements and ceiling limits in respect of bank advances, at first against certain groups of commodities and subsequently against stock exchange securities. At the beginning of the Second Plan, when it was observed that bank advances against paddy and rice had shown a particularly large increase and that the prices of these commodities had shown an abnormal rise, the Reserve Bank of India issued on May 17, 1956, for the first time, a directive asking all scheduled banks not to increase any credit limit in respect of advances against the security of paddy and rice or sanction any fresh credit limit in excess of Rs 50,000 in respect of such advances. This measure was subsequently followed by a spate of directives covering many essential commodities such as jute, raw cotton, sugar, groundnut, etc. in respect of which speculative holding was possible.

There is ample evidence to prove that the borrowers were able to evade the terms of the directives by borrowing from banks against collaterals other than those which were the subject matter of control and use the funds for financing speculation and hoarding. Thus, the decline in bank advances against paddy and rice in 1956 was more than matched by the rise in advances in shares and debentures of joint stock companies. It was evident that the proceeds of advances under the omnibus heading 'others' were being diverted to such lines of business as the authorities wanted to discourage.

The measures have been tightened, relaxed, extended, withdrawn and again reimposed from time to time according to the requirements of and the trends in the economic situation, thus showing a remarkable flexibility in the operation of selective credit control measure. Since the adoption of this weapon, the declining trend in scheduled bank advances against foodgrains is discernible. The volume of bank advances against rice and paddy declined by 66.5 per cent during April-August 1956 as compared to 46.7 per cent during the same period in 1955 (Table 2.5). From Table 2.6 it is clear that the volume of bank advances against rice and paddy declined continuously from Rs 45.64 crores in March to Rs 8.66 crores in October 1957, i.e. by about 82 per cent.

TABLE 2.5. Advances of Scheduled Banks against Food Grains (Paddy and Rice) 1955-1956

(In crores of rupees)

	Apr.	*May*	*June*	*July*	*Aug.*	*Sep.*	*Oct.*
1956							
Last week of the month	26.30	22.38	15.52	11.69	7.49	5.48	4.34
1955							
Monthly Figures	11.25	10.81	10.21	7.74	5.76	4.20	3.84

Sources: *Reserve Bank of India Bulletins*, May, July, September, November for 1955 and 1956 and also Dr. Sen, op. cit., p. 197.

TABLE 2.6. Advances of Scheduled Banks Against Food Articles in 1957 (Monthwise)

(In crores of rupees)

	Mar.	*Apr.*	*May*	*June*	*July*	*Aug.*	*Sep.*	*Oct.*
Paddy and Rice	45.64	44.79	43.64	36.12	24.84	15.00	7.94	8.66

Source: *Reserve Bank of India Bulletins*, April, May, July, September, November and December, 1957.

This method of credit control, however, had no visible impact on the prices of rice and paddy. The price indices of foodgrains went up from 84 in March 1956 to 202 in March 1967 (1952-53=100)—a phenomenon which establishes that this credit control device was not able to stabilise the prices of foodgrains though it had been in operation for over a decade. The customers of the scheduled banks turned to sources such as the indigenous bankers, the non-scheduled banks and the nonbanking financial intermediaries, thus foiling the objectives of this method.

It is our impression that the action of the Reserve Bank with regard to selective credit control was neither timely nor to the point. Sometimes the growth of bank advances against commodities was responsible for an upward trend of prices and it was a long time before the Reserve Bank actually switched on the control measures. The withdrawal of restrictions by the central bank, at times, proved to be a hasty step. This was clearly demonstrated by the withdrawal of the restriction on bank advances against paddy and rice in November, 1956. This hasty withdrawal was soon followed by a rise in the volume of bank advances against rice and paddy as will be evident from Table 2.7.

TABLE 2.7. Volume of Scheduled Bank Advances against Rice and Paddy November 1956–February 1957

(In crores of rupees)

Nov. 1956	*Dec. 28, 1956*	*Jan. 11, 1957*	*Jan. 25, 1957*	*Feb. 22, 1957*
5.09	9.61	12.85	16.13	23.18

Sources: *Reserve Bank of India Bulletins*, December 1956, January, February and March, 1957.

Thus, it is evident that the withdrawal of control measures by the Reserve Bank, sometimes, was not wise. So the Reserve Bank was forced to reimpose control over this particular use of bank credit and issued a directive on February 9, 1957, raising the margin by 10 per cent. The satisfaction expressed by the Reserve Bank over the implementation of its directives is not fully warranted by facts.

It might, therefore, be concluded that the monetary policy continued to be a double-edged one. The Reserve Bank had to ensure an adequate flow of credit to meet the genuine requirements of planned economy but at the same time check speculative excesses with their inflationary overtones. In other

words, monetary policy had to be regulated in such a way that the momentum of development could be maintained and at the same time eternal vigilance had to be kept to ensure that the pace of development did not outstrip the capacity of the economy to sustain it.

Regarding selective credit control as an independent weapon, India's experience has been similar to that of other countries. Indeed, the measure calls for a pattern of flexibility of operation in the mechanism to fit into the changing pattern of production and consumption.[25] It is difficult to make such controls effective in the manner desired unless it is reinforced by other measures of credit control.

The Reserve Bank of India succeeded to a large extent in the credit rationing effort in the Second Plan period through increasing the cost of central bank credits and exercising of credit quality control of the commercial banks. Despite their limitations, selective credit control techniques are being employed increasingly by the central banks of underdeveloped countries to regulate the credit creating powers of the commercial banks. In a developing economy like India, a selective credit control device is all the more important because of the varying degrees of responsiveness of the different sectors of the economy to changes in money supply and the rate of interest. The very imperfection of money markets in underdeveloped countries, Professor Sayers[26] argues, makes it possible to apply pressures successfully to comparatively narrow sectors of the economy and also the opportunity for applying selective controls is much greater than for applying general controls.

The selective credit control is no doubt an effective weapon to channelise credit to a purposive economy. Yet, in practice in India it is evident that bank credits were clandestinely passed on to the fields where the main consideration was professional self-advancement and sectional gains rather than the consideration of furthering the objectives of the national economy. Indeed, the effectiveness of this weapon of credit control hinges more on scrupulous regard to the objective of the directives by the banking system than on the imposition from the central bank. Adequate evidence is available to show that compliance on the part of the commercial banks with the Reserve Bank of India's directives leaves much to be desired.

The weapon can hardly be effective in view of the existence of a large non-monetised sector and Nonbanking Financial Intermediaries over which the Reserve Bank has little control[27] and this inhibits the effectiveness of the monetary policy of the Reserve Bank. Nevertheless, the consciousness of controlled expansion policy has gone a long way towards corrective measures in monetary and banking policy in India during the period.

[25] Datta, B., *Essays in Plan Economics*, The World Press Pvt. Ltd., Calcutta, 1963, p. 188.

[26] Sayers, R. S., *Central Banking after Bagehot*, 'Central Banking in Underdeveloped Countries', Oxford University Press, London, 1958, p. 131.

[27] Under the Banking Laws (Miscellaneous Provisions) Act of 1963, powers have been granted to the Reserve Bank of India to control the Nonbanking Financial Intermediaries.

IV

Effect of Monetary Policy on the Commercial Banking Structure in the Third Plan

We have appraised so far the working of monetary controls pursued by the Reserve Bank of India *vis-a-vis* the position of commercial banks in the First and Second Plan periods. This section assesses the effect of monerary policy on the commercial banking structure during the Third Plan.

The policy pursued by the central monetary authority during the Second Plan period may be characterised as 'general ease combined with selective tightness'. The policy has been changed to 'general tightness combined with selective ease' in the Third Plan. These two concepts are not as exclusive as they might appear at first sight. Some features common to both were noticeable during the Second and Third Plan periods.

The raising of reserve requirements was followed by a set of measures designed to limit the borrowing by the commercial banks from the Reserve Bank. In order to minimise recourse of banks to the Reserve Bank to finance credit expansion, a quota system was introduced and borrowings at the bank rate (both under Section 17(4)(a) and Section 17(4)(c) of the Reserve Bank of India Act, 1934) were suspended beyond the quota fixed for each scheduled bank. In other words, each bank was assigned a quota for the purpose of borrowing at the bank rate, subject to an overall ceiling. The quota for each bank was fixed for a quarter on the basis of 50 per cent of the average of the reserves required to be kept by the bank concerned under Section 42(1)of the Reserve Bank of India Act, 1934, during each week of the preceding quarter. Borrowings in excess of this quota would have to bear interest at gradually rising rates. This system did not require too large a rise in the bank rate and yet tried to restrict the commercial banks' demand for loans. The Reserve Bank thus introduced a tier system of rates for advances to scheduled banks as a measure of credit curb. The practice of making central banking aid available to banks at varying rates at the same time was patterned on the lines followed in Japan, France, Greece and some of the Latin American countries.

The Reserve Bank of India introduced a three-tier system of lending rates with effect from October 1960. Under this system, a scheduled bank could borrow upto its basic quota at the bank rate. Borrowings in excess of this quota upto 200 per cent of the quota were to be charged at 5 per cent (1 per cent above bank rate) and finally, borrowings in excess of 200 per cent of the quota were to pay 2 per cent above the bank rate (i.e. 6 per cent). The scheduled banks were also directed to raise their average lending rate so that the higher cost of borrowing could be transmitted to the ultimate borrower.

The enforcement of this regulation produced an immediate effect. Borrowings from the Reserve Bank dropped sharply from Rs 33.4 crores in the last week of September 1960 to Rs 12.3 crores in the last week of November 1960. The pressure exercised by the system was, however, sought to be relieved by the unloading of Government securities of the amount Rs 38.0 crores in these two

months.[28] Owing to the slow pace of seasonal credit contraction during the slack season of 1962 (Table 2.8) and increasing pressure on prices, a major change was effected in the rates in July 1962. A four-tier system was introduced in place of the prevailing three-tier system. The basic quota to which the bank rate was applicable was then halved to 25 per cent. Borrowings in excess of the quota upto 200 per cent were to be charged at 1 per cent above the bank rate, those between 200 and 400 per cent at 2 per cent above the bank rate, and those above 400 per cent of the quota at 2.5 per cent above the bank rate.

TABLE 2.8. Seasonal Trends in Borrowings from the Reserve Bank, Cash Ratio, Investment Ratio and Credit-Deposit Ratio etc., 1950-65

(In lakhs of rupees)

Season	*Aggregate Deposits*	*Borrowings from the Reserve Bank*	*Cash & balances with the Reserve Bank*	*Cash ratio at the end of the period*	*Investments in Govt. Securities**	*Investment ratio*	*Bank Credit*	*Credit Deposit ratio*
Slack 1950	+ 1,172	− 822	+2,699	13.0	+ 3,786	43.1	− 7,443	47.7
The First Plan Period								
Busy 1950-51	+ 1,756	+ 924	−2,521	9.9	− 6,591	34.8	+16,343	65.4
Slack 1955	+ 5,882	− 2,137	+1,241	9.1	+ 4,771	38.4	− 3,155	58.0
Busy 1955-56	+ 4,195	+ 5,035	− 674	8.1	− 3,693	33.4	+16,449	71.2
The Second Plan Period								
Slack 1960	− 2,326	− 2,702	+ 417	7.6	− 5,233	36.2	− 2,031	58.2
Busy 1960-61	+ 934	+ 2,153	−2,324	6.3	−12,632	29.4	+19,853	68.3
Slack 1961	+ 4,385	− 3,167	+1,031	7.3	+ 6,259	34.5	− 7,650	67.6
The Third Plan Period								
Busy 1961-62	+15,716	+ 617	− 44	6.7	− 2,500	30.5	+20,387	72.6
Slack 1962	+ 8,413	− 330	− 685	6.1	+11,193	34.7	− 4,210	67.5
Busy 1962-63	+ 3,568	+ 2,182	+ 419	6.2	− 9,769	29.4	+20,325	76.1
Slack 1963	+14,802	− 2,941	+4,298	7.7	+14,560	34.0	−12,090	65.7
Busy 1963-64	+ 8,451	+ 4,327	−2,944	6.1	−14,543	26.5	+37,624	79.5
Slack 1964	+21,067	− 4,334	+1,188	6.1	+25,850	34.5	−13,877	67.4
Busy 1964-65	+10,988	+12,450	+ 748	6.1	−15,425	27.2	+41,343	80.2
Outstanding as on April 30, 1965	264,081	12,618	16,142		71,923		211,905	

Source: *Report on Currency and Finance*, Reserve Bank of India, 1964-65, Statement 19, p. S29.

* At book value; includes treasury bills and treasury deposit receipts.

In the second year of the Third Plan, the declaration of emergency heightened the Reserve Bank's concern for a more stringent policy of credit restraint for restraining price advances. The four-tier system was converted into a two-tier

[28] Basu, S. K., *A Survey of Contemporary Banking Trends*, The Book Exchange, Calcutta, 1965, p. 227.

system in October 1962 in view of the possible inflationary implications of increased defence expenditure. The first two slabs were merged and banks were permitted to borrow a sum equal to 50 per cent of their statutory reserves at the bank rate (raised from 4 to 4.5 per cent) and the remaining 50 per cent at 6 per cent. For an additional quota beyond the statutory reserve, a penal rate of interest at 6.5 per cent was charged.

It was thus a control device designed to raise the cost of central bank credit and regulate the access of the banking system to the central bank. The object was to induce banks to pursue a cautious loan policy.

Let us now make a critical examination of the impact of the slab rate system of lending rates on the borrowings from the Reserve Bank of India and credit expansion. The ratio of borrowings by the commercial banks from the Reserve Bank to expansion of bank credit is a measurement of the Reserve Bank's direct contribution to credit expansion. It also indicates the attitude of the central bank authorities towards credit expansion. A change in this ratio also reflects shifts in the credit expansion policy of scheduled banks themselves. Table 2.9 throws an interesting light on the ratio of borrowings from the Reserve Bank of India to bank credit. The borrowings from the Reserve Bank were maximum (Rs 35.5 crores) in 1956. The ratio of borrowings to bank credit was at 7.1 per cent that year—the highest during the entire Second Plan period. This trend is attributable to the relatively high demand for credit in excess of deposit growth, and running down position of cash. The cash ratio had declined to 8.6 in 1956 from 10.3 per cent in 1955.[29]

TABLE 2.9. Ratio of Borrowings from the Reserve Bank to Bank Credit, 1955-1960

(In crores of rupees)

(Average of Fridays)	*Aggregate Deposits* (1)	*Borrowings from the RBI* (2)	*Bank Credit* (3)	*Percentage of* (3) *to* (2) (4)
1955	980.9	17.7	603.9	2.9
The Second Plan Period				
1956	+87.9	+35.5	+140.1	
	1,068.9	53.2	744.0	7.1
1957	+180.3	+ 4.4	+129.7	
	1,249.2	57.6	873.7	6.5
1958	+252.3	−41.4	+ 19.0	
	1,501.5	16.2	892.7	1.8
1959	+218.7	+ 2.3	+ 69.2	
	1,720.3	18.5	961.9	1.9
1960	+192.9	+19.9	+145.2	
	1,913.3	38.4	1,107.1	3.4

Sources: i) *Trend and Progress of Banking in India,* Reserve Bank of India, various issues.
ii) *Statistical Tables Relating to Banks in India,* Reserve Bank of India, various issues, and
iii) *Reserve Bank of India Bulletin,* August 1961, p. 1223.

[29] *Trend and Progress of Banking in India,* Reserve Bank of India, 1956, p. 14.

It is evident that the Reserve Bank's advances in 1956 made possible the rapid expansion of bank credit in industry in the Second Plan period by supplementing the resources of the banks. As against this trend, during the period 1958-59 borrowings from the Reserve Bank were relatively small as increase in deposits was larger in proportion to the demand for credit. Demand for bank credit was virtually stagnant in 1958. The commercial banks, therefore, reduced their indebtedness.

In 1960 with an increase in industrial and agricultural output, a rise in overall investment both in the public as well private sectors, the demand for bank credit increased faster than deposits and commercial banks had to resort to larger borrowings which increased by Rs. 38.4 crores in 1960 against Rs. 18.5 crores in 1959.

It will be observed that during the period under review the expansion of bank credit was not limited by the amount of deposits held by the banking system but was dependent on their ability to borrow from the Reserve Bank. In other words, the principle followed by the banks in their lending policy during the Second Plan period was not limited by a credit-deposit ratio but the needs of the economy. The reliance of banks on the Reserve Bank for funds has been gradually increasing with the rising trend in economic activity in the developing economy. It proves that the banks have not made positive efforts to raise funds from other sources.

The efficiency in mobilisation of deposits is the linchpin of the banking business. Deposits have not kept pace with the growing demand for funds with the result that during the busy season the banking sector has had to resort to large borrowings from the Reserve Bank. As the economy gains further acceleration under the aegis of the Plans, the demand for funds for productive purposes will rise at a much faster rate. How then should the banking sector proceed to meet its share of demand? No serious attempt has, as yet, been made to project the quantum of deposits required to meet the demand for funds over a period of time. A set target induces a sense of purpose and direction which in turn stimulates action.

The large difference in the ratio of deposit to income between the urban and rural areas is indicative of the potentiality that remains to be exploited in the rural areas. The deposit-income ratio in the rural sector is lower by as much as 33 to 54 per cent than that in the urban sector.[30] The rise in national income, huge public expenditure in the Plans and a higher price level of agricultural commodities have enormously extended the banking potentiality of these areas. There is ample evidence that vast funds in rural areas are kept hidden in gold, silver, and property or held in currency notes in the absence of banking facilities. It is estimated that there are still about a thousand unbanked towns in the country excluding underbanked centres. It has to be remembered that the interbank agreement on deposit interest is in disarray and, therefore, a fair interest rate structure is essential for the mobilisation of deposits especially in rural areas where the green revolution is creating prosperity. The depositor,

[30] *State Bank of India Monthly Review*, July 1965.

however small he may be, has to be cultivated much more effectively than at present. The concept of importance in relation to the size of the customer is as dead as the dodo.

Let us now revert to our original discussion. Table 2.10 brings out clearly that by 1955–56 there was heavy pressure on the banking system. The credit deposit ratio rose as high as 73.0 from 22.1 per cent in 1950–51. Borrowings from the Reserve Bank increased from Rs 12.41 crores to Rs 65.08 crores during the same period. Cash reserves also declined from Rs 93.30 crores to Rs 84.73 crores and the cash ratio fell from 10.6 to 8.1 per cent. Deposit growth during the period was not substantial and borrowings contributed largely to the

TABLE 2.10. Borrowings from the Reserve Bank of India, Expansion of Bank Credit and other Related Data (Scheduled Banks only), 1950-51–1966-67

(Amounts in lakhs of rupees)

Last Friday	*Aggregate Deposits*	*Borrowings from RBI*	*Total cash and Balances with RBI*	*Cash Ratio of (3) to (1)*	*Investment*	*Investment–Deposit Ratio of (5) to (1)*	*Total Bank Credit*	*Percentage of (7) to (2)*	*Credit-Deposit Ratio of (7) to (1)*
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
The First Plan Period									
1950-51	88,061	1,241	9,330	10.6	N.A.	N.A.	54,693	2.2	22.1
1955-56	104,315	6,508	84,73	8.1			76,125	8.5	73.0
The Second Plan Period									
1956-57	109,491	6,345	8,717	8.0	35,935	32.8	78,164	*	71.4
1957-58	131,668	4,458	11,700	8.9	38,465	29.2	89,080		67.7
1958-59	154,887	1,781	12,430	8.0	56,490	36.5	89,917		58.1
1959-60	178,678	1,942	12,062	6.8	72,464	40.6	98,749		55.3
1960-61	174,606	9,453	11,658	6.6	55,858	31.99	131,954		75.57
The Third Plan Period									
1961-62	192,187	5,304	12,346	6.42	60,139	31.29	140,761	3.7	73.24
1962-63	204,226	7,128	12,571	6.16	59,276	29.02	158,801	4.4	77.76
1963-64	228,510	8,416	14,760	6.46	63,969	27.99	181,646	4.6	79.49
1964-65	258,330	15,302	16,245	6.29	71,818	27.80	203,370	7.5	78.73
1965-66	294,983	7,352	17,080	5.79	81,069	27.48	228,814	3.2	77.57
Period after the Third Plan									
1966-67	342,472	13,972	21,562	6.30	89,280	26.07	269,247	5.2	78.62

Sources: Compiled by the writer from
i) *Report on Currency and Finance*, Reserve Bank of India, 1964–65, Statement 20, p. S32.
ii) *Reserve Bank of India Bulletin*, October 1967, pp. 1337–1338.

* For percentage of Col. (7) to (2) for the Second Plan Period See Table 2.9 (Col. 6).

expansion of credit. The same trend was also noticeable in 1959–60. Borrowings from the Reserve Bank increased from Rs 17.81 crores in 1958–59 to Rs 19.42 crores in 1959–60 and rose to a high level of Rs 95 crores in 1960–61. The cash ratio dropped from 8.0 to 6.6 per cent during the same perod. Investments, of course, showed a substantial rise but that is due to investments of PL 480 funds by the State Bank of India in Government securities. The correct picture is that investments actually declined and the investment ratio fell in 1960–61.

During the Third Plan period the impact of central banking policy was felt in three ways. Table 2.10 brings out that the banking system was generally tight during the entire planned period. This is abundantly demonstrated from the rising credit-deposit ratio. With the rising tempo of industrial activity, the ratio percentage shot up from 73.24 in 1961–62 to 77.57 in 1965–66. The progressive decline in the cash ratio from 6.42 per cent in 1961–62 to 5.79 per cent in 1965–66 indicates that the demand for credit was high. All these factors were responsible for heavy reliance on borrowings from the Reserve Bank. Borrowings by the scheduled banks increased from Rs 53.04 crores to Rs 153.02 crores during 1961–62 and 1964–65 respectively, a rise of about 300 per cent. Borrowings declined in 1965–66 but again shot up to Rs 139.72 crores in 1966–67. The investment deposit ratio also reflected a consistently declining trend from 31.99 in 1961–62 to 27.48 in 1965–66 and it dropped further to 26.07 per cent in 1966–67. This indicates that many banks were forced to acquire securities for statutory requirements more than proportionately to the accretion of deposits.

Seasonal credit expansion in the 1964–65 busy season at Rs 413 crores was Rs 37 crores higher than that of 1963–64 busy season (Table 2.8). The scheduled banks resorted to the Reserve Bank accommodation to a large extent in 1964–65 and borrowings increased about three times as compared to the increase in 1963–64. The seasonal trends in respect of borrowings, bank credit, total deposits, and investments during the entire planned period are clearly brought out in this table. It shows that banks had used up their cash resources to the maximum extent during the busy season. Lower cash ratio, larger borrowing from the Reserve Bank and a considerable decline in the investment portfolio in the busy season are indicative of the fact that there was heavy pressure on banks during the developmental planning era.

In the busy season banks' expansion of credit is synchronised with the characteristic contraction of investments in Government securities. This scissor-like behaviour (see Chapter 4) of banks' earning assets faithfully indicates the tightness of restrictive credit policy. Ordinarily, this situation should be characterised by a virtual disappearance of excess reserves. The term 'excess reserve' may be defined as the sum total of cash in hand and balances with the Reserve Bank of India minus required statutory reserves. Again, excess reserve minus outstanding bank borrowings is known as 'free reserve'. Variation in free reserve is, therefore, a better indicator of the state of liquidity of banks. A still more sensitive indicator of bank liquidity is the ratio of free reserve to deposits. Thus, it will be supposed that banks are tight when free reserves are abnormally low or negative, and loose when they are high. It can be seen that free reserves will tend to decline when the banks' borrowings from the Reserve

Bank are rising, and will correspondingly rise when bank borrowings tend to level off or are actually falling. If the scissor-like behaviour of the banks' earning assets is associated with declining free reserves, the banks should unambiguously be considered tight. This happened in India in 1956 and all through the Third Plan.

Table 2.11 shows the trends in scheduled banks' assets, borrowings from the Reserve Bank and their operating ratios during the first three years of the Third Plan period and brings out restrained monetary conditions of the commercial banks during the period under analysis. The progressive decline and negative sign in free reserves demonstrate exceptional stresses in the financial position of banks. It also means that the monetary policy pursued by the Reserve Bank of India was not fully in conformity with the developmental needs of the planned economy. The act of frequently changing the slab system of lending rates is a clear instance of increasing the bank rate through the backdoor and of reducing its role to one of following the market instead of leading it. It also suggests that adequate consideration was not given to the factors prevailing in the money market. A final change in the decision to switch over to a two-tier system would have proved the foresight and bold vision of the monetary authorities. Even then, the slab system has not been successful as will be evident from the increasing reliance of banks on the Reserve Bank for borrowings and rising bank credit expansion. The larger borrowings from the Reserve Bank reveal a sharp conflict of objectives and means. That is one reason why the system of quotas and slab rates was replaced by a new controlling device.

There was a rise of 14.8 per cent in the wholesale price index over the year in September 1964, making it 158.6 (1952–53=100) and bringing forth

TABLE 2.11. Scheduled Banks' Assets, Borrowings from the Reserve Bank and Their Operating Ratios, 1961-1964

The Third Plan Period
(First Three Years)

(In crores of rupees)

(Average of Fridays)	1961-62	1962-63	1963-64
1. Total Deposits	1,809	2,024	2,194
2. Bank Credit	1,278	1,432	1,568
3. Investment in Government Securities	585	636	691
4. Total Cash Reserves	126	132	139
5. Borrowings from the Reserve Bank Outstanding	21.7	19	22.6
*6. Excess Reserves	15	14.8	13.8
7. Free Reserves (6-5)	−6.5	−4.5	−8.8
		(as percentages)	
8. Cash-Deposits	7.0	6.6	6.3
9. Investment-Deposits	32.3	31.5	31.5
10. Bank Credit-Deposit	70.7	70.7	71.5

* Averages of monthly data.

Sources: *Report on Currency and Finance,* Reserve Bank of India, 1963-64, (Statements 15 and 17) and 1962-63 (Statement 24).

inflationary pressures. As a remedial measure the bank rate was pushed up from 4.5 to 5 per cent on September 25, 1964. Simultaneously, the Reserve Bank took more steps to reinforce the effect of the rise in the bank rate. The system of quotas and slab rates was replaced by a new controlling device by which the borrowing power of the bank was related to its *net liquidity position.* The net liquidity was defined to mean the total of a bank's cash, balances with the Reserve Bank and other notified banks and balances in current accounts with other banks and investments in Government securities less its total borrowings from the Reserve Bank and the State Bank, as a proportion of its aggregate demand and time liabilities[31] as reported every Friday under Section 42 of the Reserve Bank of India Act. To facilitate financing of food procurement and allied activities, the Reserve Bank announced in March 1966 a concessional measure in terms of which refinance in respect of food procurement advances in excess of the previous year's maximum level would be counted as part of the bank's borrowings from the Reserve Bank for the purpose of computing the liquidity ratio.

A bank was allowed to borrow unlimited amounts from the Reserve Bank at the prevailing bank rate, that is, at 5 per cent, as long as the net liquidity position as explained above was at or about 28 per cent. But for every one percentage point fall in this position, the rate of interest to be charged on the entire amount of the bank's borrowings will go up by 0.5 per cent. In other words, under the new system, every 1 per cent drop in the net liquidity position will push up the rate of interest not only on further borrowings, but also on the amounts already borrowed earlier at a lower rate.

The old policy of control could have been circumscribed by the banks by expanding credit even with loans obtained from the Reserve Bank. The new system on the other hand discouraged bank credit expansion because of its adverse effect on the stipulated liquidity position. Secondly, the new system is simpler to administer and easier to understand besides being more equitable to both large and small banks. An essential part of the new control system is the fixation of a maximum rate (10 per cent) on commercial banks' advances.

Contrary to expectations, however, the rise in the bank rate did not prove adequate in stemming the spiralling forces of inflation, and prices recorded a sharp rise. The wholesale price index was 16 per cent higher in February 1965 than the previous year. Again on February 17, 1965, the bank rate was raised by 1 per cent to 6 per cent. The announcement was a definite emphasis on a Dearer Money Policy and it demonstrated the Reserve Bank's growing concern over the price trend. The policy of dearer money was expected to restrain the pace of monetary expansion. The announcement was accompanied by a directive which raised the required liquidity ratio to 30 per cent (as against 28 per cent under the September 1964 scheme). For every decline of 1 per cent or a fraction thereof in the net liquidity ratio (instead of every drop of 1 per cent in the net liquidity ratio under the former scheme) the rate of interest on the entire amount of borrowings will be pushed up by 0.5 per cent. Thus, by directly raising the

[31] *Report on Currency and Finance*, Reserve Bank of India, 1964–65, p.14.

borrowing rate and by increasing the penalty implied in higher liquidity ratio, the Reserve Bank tightened on the banks' borrowings in two ways.

The credit policy for the 1965–66 busy season continued broadly the previous season's policy. The Bill Market Scheme was revived. The Reserve Bank agreed to provide refinance at bank rate to banks which made advances to finance 90-day bills for defence, 60-day bills for packing credit to exporters and food procurement and allied activities while making credit dearer for other purposes. It also directed the banking system to secure prior approval from it before a single party was granted credit above Rs 1 crore.

Under the monetary policy for 1965–66 the Reserve Bank of India had ensured adequate availability of credit only for three sectors—defence, exports, and food procurement. Under the new policy for the busy season of 1966–67 it became possible for a scheduled bank to secure from the Reserve Bank, in addition to the funds it could obtain because its net liquidity ratio was above 30 per cent, *a tranche of refinance* at the bank rate equal to 10 per cent of its net liquidity ratio at the end of the slack season (end-October, 1966). Even a bank with a net liquidity ratio of 30 per cent or below was allowed refinance at the bank rate upto 10 per cent of its actual net liquidity ratio position at the end of the slack season. The increase in advances to State Governments and their agencies over the level of end-October 1966 in respect of food procurement and allied activities, continued to be eligible for refinance at the bank rate as also the credit in respect of rupee export bills. A penal rate of 10 per cent was prescribed for borrowings from the Reserve Bank exceeding the amounts that could be borrowed at the bank rate. If, however, such excess borrowings were either continuous or of a large order, the Bank retained the discretion to charge a special penalty rate on the 'excess' of borrowings from the Reserve Bank over what the banks were entitled to at the bank rate.[32] A directive was also issued to Indian scheduled banks having an aggregate demand and time liabilities of Rs 50 crores or above as on September 30, 1966, and all foreign banks indicating that 80 per cent of their seasonal credit expansion should be directed towards industry and against export and import bills or only against export and import bills. The definition of industry was also enlarged to include plantation, mining, transport, and generation and distribution of power. Further, banks were advised to pay particular attention to the credit needs of small industries. The commercial banks were also urged to assist agricultural operations by investing in the debentures of land development banks. Thus, credit expansion in the 1966–67 busy season was meant to meet only the genuine needs of production.

In contrast to the busy season of 1965–66, the rate of credit expansion in the 1966–67 busy season was faster. The increase in credit amounted to Rs 425 crores which was Rs 116 crores higher than that in the 1965–66 busy season (Rs 309 crores), the rate of expansion rising to 19 from 15 per cent in the previous busy season as Table 2.12 shows.

With the onset of the 1966–67 busy season the money market continued to be tight. Banks had to borrow heavily from the Reserve Bank in order to replenish

[32] Ibid., 1966–67, pp. 17–18.

TABLE 2.12. Scheduled Bank Data—Busy Season, 1964-65–1966-67

(In crores of rupees)

Item	The Third Plan Period (Last Two Years)		Period After the Third Plan
	1964-65 (1)	*1965-66* (2)	*1966-67* (3)
1. Aggregate Deposits	+106.4	+213.9	+167.5
(a) Demand	+ 43.5	+120.6	+110.0
(b) Time	+ 62.9	+ 93.3	+ 57.5
2. Borrowings from Reserve Bank of India	+124.5	+ 28.5	+ 40.8
3. Borrowings from State Bank of India and/or notified banks	+ 8.6	+ 4.6	+ 5.5
4. Bank credit	+407.4	+309.5	+425.3
5. Investments in Government securities	−153.8	− 27.3	−198.1
6. Cash reserves	+ 7.6	+ 5.4	+ 11.5

Source: *Report on Currency and Finance*, Reserve Bank of India, 1966–67, p. 15.

their resources position which was becoming strained under the busy season pressure. Borrowings from the Reserve Bank increased by Rs 66 crores in 1966–67 in contrast to a sharp decline of Rs. 80 crores in 1965–66 (Table 2.10). This reflected the larger demand for bank finance in the 1966–67 busy season which led to greater recourse by banks to the Reserve Bank than in 1965–66.

The need for stepping up industrial production is urgent. The industrialists hold that, for a variety of reasons, the increase in the demand for bank funds from industry is real for an economic boost, whereas commercial banks have been experiencing increasing difficulties in meeting the growing demands of industry. If the productive apparatus is not to suffer a breakdown, central bank credit at the bank rate and sometimes even at a concessional rate, must be made available more freely and in ampler measure. The Reserve Bank of India must, however, keep a careful watch that advances by the banks are actually utilised for productive sectors. Production, particularly the production of quick-yielding assets, appears to be the only means by which we may be able to arrest the inflationary forces and steer the economy towards progress with stability.

V

Monetary Policy during the Fourth Plan Period (1969-74)

The broad features of the earlier credit policy continued and the structure of refinance facilities remained generally the same except for some modifications in regard to refinance for food procurement advances. While the emphasis was on general credit restraint, measures were also taken to encourage the flow of resources to certain sectors.

There was no relaxation of monetary restraint in the credit policy for 1974–75 as there was no evidence of any decrease in the inflationary pressures in the

economy. However, to enable commercial banks to meet the essential needs, the following modifications were made:

(i) The minimum statutory balance to be maintained by the scheduled commercial banks with the Reserve Bank was reduced from 5 to 4 per cent of the total demand and time liabilities.

(ii) The minimum of assets that constitute the statutory liquidity requirements (SLR) under Section 24 of the Banking Regulation Act, continued at the previous level of 33 per cent.

(iii) The minimum net liquidity ratio (NLR) relevant for lending by the Reserve Bank at the bank rate was reduced from 40 to 39 per cent, effective December 28, 1974. The maximum rate chargeable for refinance under the NLR system remained at 18 per cent per annum. The rates of interest applicable to the borrowings from the Reserve Bank at different levels of NLR maintained by banks with effect from December 28, 1974, are given below:

Net Liquidity Ratio (NLR)	Rates of interest on borrowings from the Reserve Bank of India (Per cent per annum)
39 and above	9
38 „ „ but below 39	10
37 „ „ „ „ 38	11
36 „ „ „ „ 37	12
35 „ „ „ „ 36	13
34 „ „ „ „ 35	14
33 „ „ „ „ 34	15
32 „ „ „ „ 33	16
31 „ „ „ „ 32	17
Below 31	18

(iv) The bank's ordinary recourse to the Reserve Bank for refinance was limited to an amount equal to 1 per cent of its demand and time liabilities as on September 27, 1974.

(v) Refinance for public food procurement operations will be available when the overall food procurement credit exceeds Rs 300 crores.

(vi) The flow of Reserve Bank funds through the bills rediscounting scheme would be encouraged in preference to assistance through refinance.

The policy provides selectively for the deployment of credit for sustaining investment, augmenting production, and facilitating better distribution of essential commodities. The continuing policy of restricting monetary expansion will have, it is apprehended, some effects on the rate of deposit accretion. Bearing in mind the liquidity requirements, the banks will have to plan their credit deployment on an extremely selective basis and endeavour to meet high priority claims as far as possible from their own resources. Primary consideration has to be given

to increased agricultural production and the building up of an adequate public distribution system for food. The special requirements of export credit should continue to be accorded high priority (see Chapter 10). In the public sector, working capital requirements of manufacturing units for expanding production deserve prior consideration. Selective credit controls should continue in order to discourage speculative hoarding of sensitive commodities in the private sector. In brief, the inflationary potential in the economy is still very considerable and the general accent of monetary policy is still one ot tightness as the control of inflation has to continue as a basic objective. But the needs of some of the sectors which face special difficulties will have to be examined with reference to the extent to which credit could assist in a solution of their problems. Credit expansion will have to be limited to the banks' own available resources. The Reserve Bank's assistance which is essentially created money can only be minimal and temporary. This aspect of the constraint on the banks' resources position calls for an even greater emphasis than in the past on selectivity in deployment of credit. Primary emphasis will have to be on sustaining investment and assisting production in core sectors and other essential lines as well as on mass consumption goods and exports.

VI

Observations

The First Five Year Plan period reveals several distinct phases of booms and recessions which were not, however, deep enough to produce violent fluctuations in prices so that during the First Plan period as a whole there was comparative stability of prices. As the Second Plan progressed, inflationary forces gathered momentum. Over the five-year period of the Second Plan the rise in the general index of wholesale prices was about 30 per cent; food articles as a group went up by some 27 per cent; manufactures by a little over 25 per cent; industrial raw materials by 45 per cent. The rise in prices could not be checked and the tempo of increasing production could not be maintained.

During the Third Plan period owing to stagnation of food-grains output, heavy defence expenditure, investment in wrong channels, hoarding and cornering of essential articles in short supply, the wholesale index rose steeply from 129.8 in March 1962 to 208.3 in May 1967 (1952–53=100). This price rise of more than 15 per cent can not be treated as a 'functional price-rise' and, therefore, does not fall into the category of a slow and steadily rising price level which is conducive to a growth process.

In such circumstances, many have failed to detect a meaningful price policy in the measures taken by the Reserve Bank of India during the planning era. The continued rise in prices is acting, and will act, as a brake on the flow of resources to investment. Unless the authorities in India are firm in their attack and the monetary policy, with a particular emphasis on selective credit controls, is reinforced by suitable fiscal remedies which create the ground for a system of rigid physical controls and allocations, the atmosphere of financial stability

necessary for economic uplift will not emerge. During 1966 and 1967 inflation in India became a more complex phenomenon; judging by the price rise there was inflation, and judging by the fall in production and idle capacity, there was recession. Stability at present, therefore, has two aspects—controlling inflation in the aggregate and eliminating sectoral recession. In the long run the demand-pull forces are perhaps more important in explaining the price rise in India. But, at the same time, the basic shortages prevailing on the supply side and their consequences, which have produced a marked cost-push in the short run, cannot be neglected. Thus, the present excessive price rise has resulted from an interaction between the demand-pull factors and the cost-push forces.

It appears that there was no predetermined plan on the part of the central monetary authority for the use of the various credit control measures. There was, indeed, no effective coordination between the various measures adopted. Besides, in the early days of the introduction of the monetary weapons, there were no conventions among the Indian banks regarding the use of these monetary measures. In other words, the banking system was not privy to the new monetary discipline that was introduced extempore in course of the Plan period. The bank rate, for instance, has not been deliberately used. It was revised in an upward direction because of some fundamental changes in the whole structure of interest rates. Other monetary weapons, including the selective credit control device, were rapidly developed during two periods of inflationary pressures during the Second Five Year Plan period (first between March 1956–July 1957 and the second between October 1959–October 1960). The monetary policy of the Indian central bank, though aiming at 'controlled expansion', in retrospect may be described as one of cautious improvisation.[33] In order to enable the central banker to feel the pulse of the market correctly a regular and continuous exchange of ideas and views between the central bank and commercial bank representatives beforehand is necessary instead of introducing impromptu monetary measures.

Coming to the fiscal policy, it may be pointed out that the tax system in India does not seem to have been worked fully in conformity with the needs of a developing economy. If the primary problem in a developing economy is to raise the saving-income ratio, the main task before the fiscal authorities in such an economy should be to promote capital formation. To achieve capital formation at a higher rate, it is necessary that taxation as a proportion of national income should rise as national income rises. There is ample scope for reforms in both direct and indirect taxes so as to fulfil the objective of mobilising the surplus currently generated in the economy for purposes of economic development. All this inevitably underlines the essential bond of unity between the monetary and fiscal policies. There is no objective law which neatly demarcates the sphere of the operations of each. The nature of the economic problem in the developing economies is such that it can be tackled only through simultaneous adoption and adaptation of the monetary and fiscal policies along with other instruments

[33] Cf. "Some Thoughts on Monetary Management", *Tata Quarterly*, April 1961, pp. 51–52.

of economic policy, so as to form a 'package deal' approach to the whole problem.[34]

It must be borne in mind that the relationship between monetary policy and fiscal policy is complementary and that both are used as instruments of an overall economic policy. While fiscal policy deals with the structural aspects of the economy, monetary policy gives a more flexible approach to changing circumstances. The focal point in the debate then is whether the required restraints that are to be exercised in the aggregate demand can be brought about more effectively by fiscal policy or by monetary policy alone. Indeed, a reform of fiscal policy does not rule out a correct monetary policy since the latter is complementary and, therefore, equitable and indispensable to it. It is interesting to note that the main constituents of the expansion in the liquidity of the economy have been the fiscal operations of the Government. In fact, it is Government expenditure that has been a substantial factor behind monetary expansion. A drastic pruning of nonessential expenditure in order to reduce the strain of excess demand is, indeed, urgent. The Reserve Bank of India would be failing in its responsibilities if it does not administer a stern warning against the continuance of deficit financing. It is the duty of central banker to caution the Government about the danger to economic efficiency and the social injustice of inflationary planning.

When nearly one sixth of the Centre's Plan outlay depends on inflationary finance, the Government will find it hard to sustain its claim that it is doing its best to hold the price line, unless it can also prove that developmental outlays are directly contributing to an increase of output. Many of the projects undertaken earlier cannot, perhaps, be abandoned at this stage but the expenditure will not be productive of any immediate benefits. There is stronger reason, therefore, for being selective about the rest of the development outlays with a view to diverting some of them to those sectors where they may be immediately productive, or to reducing the scale of deficit financing. The real need is to accelerate the pace of investment in areas in which it can be productive in the short run; such investment can also help to create employment and stimulate demand. Stimulation of demand itself is likely to give an upward push to the economy as a whole. Development aims at raising the standard of living, a rise in the level of consumption is to be regarded as an end to be achieved. In this sphere the criterion is not merely what the individual wants or needs but what the collective needs are and how best they can be met. The role of a consumption policy in the strategy of India's economic development must, therefore, be fully appreciated.

The preponderance of currency in the composition of the total money supply has set up a monetary pattern that militates agaist effective and prompt credit control. In India the currency in circulation forms about two thirds of the total money supply, the rest being deposit money.[35] The monetary framework in

[34] Cf. *The Per Jacobsson Foundation Lecture*, delivered by Dr. Deshmukh, on October 1, 1965, Washington, D.C., p. 30.

[35] Deposits now stand at 55 per cent as against 38 per cent in 1951. Even so, the proportion of currency remaining outside the banking system is very high by international standards.

India is not, therefore, comparable either in coverage or in the degree of integration with that in the West. Besides, the existence of a fairly large nonmonetised sector—about 35 per cent of the total national income being outside the purview of monetary transactions—sets limitations on the extent to which monetary policy can make itself felt. Furthermore, even within the monetised sector, the Reserve Bank of India's policy seems to be effective only in respect of the organised sector which comprises only 50 per cent of the Indian money market. The Reserve Bank's control over commercial banks can not be fully effective as trade and industry have had the obvious opportunity to fall back on the unorganised monetary sector to supplement their resources.

Under such circumstances, overall restrictive credit policies would be likely to raise the cost, as well as restrict the availability, of credit to those units which depend mainly upon the organised sector for their credit requirements. These units may be forced to restrict their scale of operations while the other units which can obtain funds through other channels may not feel the restraint and, therefore, may maintain their operations on a larger scale. The extent to which the overall restrictive policies force the firms engaged in productive activity to reduce their scale of operations or their growth, will have serious repercussions on the size and the growth of output and this may add to the inflationary pressures and make the situation awkward. In short, such overall restrictive policies may produce a peculiar situation in which the organised units are likely to be subjected to a discriminatory financial stringency which may ultimately divert productive resources to less useful channels and upset the Plan priorities.

The indigenous bankers maintain strict secrecy of operations and it can be presumed that a large portion of the 'black market money' has infiltrated into these unorganised channels. The crux of the problem is that these accumulated gains arising mainly from illegal transactions cannot be brought into books or into bank accounts. It is difficult to control the regular activities of the indigenous bankers who may be classified as a crude type of non-bank financial intermediary. This difficulty greatly increases when the indigenous bankers operate with 'black market money' the amount of which is stated to be enormous. The private holdings of 'unaccounted money' are being used, to a large extent, for commodity speculation and constitute an important factor of an inflationary price rise. This 'black market money' which helps speculative dealings, necessarily reduces the effectiveness of monetary policy in India.

Broadly speaking, the effectiveness of monetary policy largely depends on the degree of integration in the economy and the extent to which the commercial banks cater to the credit needs of the economy. Mr. Wilson[36] suggests that for fuller integration of the indigenous sector with the organised sector:

> ....the link between the commercial banks and the indigenous institutions must be considerably strengthened.....There is much that is good in indigenous practice and, if both sides are willing, it should not be impossible over the years to effect a graft which will provide the vigour needed for further development.

[36] Sayers, R. S., Ed., *Banking in the British Commonwealth,* Clarendon Press, Oxford, 1952, pp. 215-216; see J. S. G. Wilson, "The Business of Banking in India".

In considering the trends of the monetary policy of the Reserve Bank of India and their effects on the operations of the commercial banks, it would be interesting to explore the Radcliffe mechanism which has stimulated a good deal of discussion in recent years. The positive finding of the Radcliffe Committee is that the central piece of monetary action is not the supply of money but the structure of interest rate or the liquidity of the whole economy. If a dear money policy in the shape of higher interest rates is to be effective, it would have to reduce the liquidity of all semi-liquid assets in the sense that the onwers of such semi-liquid assets would not be able or willing to readily convert them into cash since this would entail a capital loss on them; for when the interest rate is raised, the capital value of the outstanding assets falls. In other words, the Radcliffe Committee's approach is not to restrict the supply of money but to strike more directly at the liquidity of the spenders and of banks and financial intermediaries which finance the spenders.

Stated differently, the Committee recommends that the monetary policy should seek to influence something more than the supply of money—it should aim at influencing the state of liquidity of the whole economy. The Committee's thesis on the importance of the state of liquidity as the crucial factor in the community's spending decisions has, however, been challenged. An important criticism is that the Radcliffe policy is haphazard and the Committee has never defined the liquidity concept and its relationship to spending motivation. While the Committee considers the structure of liquidity or the structure of interest rates rather than the supply of money as the central piece of monetary action, it does not mean that the supply of money is unimportant. In fact, the supply of money is only one of the elements in the whole complex of factors which make up the liquidity of the system. In bringing out this salient truth the Radcliffe Committee, indeed, has made a significant contribution to the understanding and the use of monetary policy.

The growth of Nonbanking Financial Intermediaries (NFI) poses a problem for monetary control in India which is analogous to the threat presented to monetary policy by the shift of deposits from banks to the NFI in the USA, UK, and South Africa. The present methods of credit control discriminate against commercial banks in their competition with the NFI, weakening the effectiveness of monetary policy in the long run and, therefore, an extension of the central bank's regulatory powers has been advocated.[37] The Reserve Bank of India's policy of 'controlled expansion', to become more effective, requires that there should be an equal degree of control over the commercial banking structure and the more important categories of the NFI. A credit restraint policy applicable to the banking sector only may not be fully effective in achieving economic growth and maintaining monetary stability. Monetary policy should be reoriented and redesigned in such a manner that at least the more important NFI operating in the organised sector, are able to perform their function of activating idle hoards in a way which will prove to be socially desirable. The central issue today is

[37] Gurley and Shaw, *Money in a Theory of Finance*, The Brookings Institution, Washington D.C., 1960, pp. 237-241.

how to ensure that the savings of the community can be channeled into productive purposes as envisaged in a total planned effort with a minimum leakage into the unwanted by ways of the economy. If the operations of the more important Indian NFI come under the purview of the Reserve Bank of India's selective credit control measures, an appreciable amount of such hoards is likely to be channelised into priority sectors to keep up the growth and welfare objectives of development planning.

Monetary policy must serve the triple ends of maintaining a high level of employment, stimulating expansion of the real national income, and at the same time keeping a reasonably stable value of money. An active monetary policy is meant to bring about an effective mobilisation of the actual and potential savings through financial intermediaries which form the spectrum of financial assets of the money market. These resources are then to be turned into investment through the adoption of a credit structure so built that it answers the needs of development in accordance with the priorities laid down by the economic policies.

In an economy the credit needs of which are growing and where investment is being undertaken within the confines of an overall plan, it is important that the regulation of credit expansion should be linked, both dimensionally and directionally, with the overall requirements of the plan. The promotional function of monetary policy is demonstrated in the measures taken to enlarge the purposive institutional supply of rural and industrial credit and the attention paid to insulating sensitive sectors, such as the export industry, from the impact of a general credit squeeze. The essence of the developmental and progressive role of monetary policy lies in extending the benefit of access to the scarce resource of banks' funds in accordance with the needs of the borrowing unit, determined not only by its size but also by the type of production in which it is engaged. All in all, the policy pursued by the Reserve Bank of India during the planned period can be characterised as a cautious approach to the monetary discipline wherein the central theme has been credit rationing and regulation without, at the same time, allowing the flow of supply of funds being sapped up due to excessive stringent measures to ensure a steady and stable growth of national economy. At times, a few extraneous factors supplemented by the militant explosions of the affected sectors tended to foil the efficacy of the measures and caused retardation in the march of the central bank to hold the economy in the right perspective of planned development.

To conclude, the exercise of monetary policy calls for deep technical knowledge and an experience that most politicians do not possess. That is why it must be entrusted, as far as possible, to specialists and not be too closely dependent on general policy. In the field of monetary policy any mistake or, what is even more serious, a simple failure to act when action is called for, has deep repercussions on the lives of the members of the entire community.

Annexure 2.i

The chart gives a condensed picture at a glance of the principal monetary policy measures taken by the Reserve Bank of India since May 1973 to September 1975.

Principal Monetary Policy Measures Taken by the Reserve Bank Since 1973

Date of Circular	*Raised with effect from*	*Raised/Lowered from (percentage points)*
1	2	3
	I Bank Rate	
May 30, 1973	May 31, 1973	6 to 7
July 22, 1974	July 23, 1974	7 to 9
	II Statutory Cash Reserve Ratio[1]	
May 30, 1973	June 29, 1973	3 to 5
Aug. 14, 1973	Sep. 8, 1973	5 to 6
Aug. 14, 1973	Sept. 22, 1973	6 to 7
May 14, 1974	June 29, 1974	7 to 5
October 29, 1974	Dec. 14, 1974	5 to 4.5
Oct. 29, 1974	Dec. 28, 1974	4.5 to 4
	III Statutory Liquidity Ratio[1]	
Nov. 30, 1973	Dec. 8, 1973	30 to 32
April 18, 1974	June 29, 1974	32 to 33
	IV (i) Net Liquidity Ratio[1]	
Mar. 17, 1973	Mar. 30, 1973	36 to 37
May 30, 1973	June 29, 1973	37 to 39
Aug. 14, 1973	Sept. 8, 1973	39 to 40
July 22, 1974	July 23, 1974	Remains at 40
Nov. 5, 1974	Dec. 28, 1974	40 to 39
	IV (ii) Maximum Rate Chargeable by the R. B. I.	
Nov. 16, 1973	Nov. 16, 1973	12 to 15
July 22, 1974	July 23, 1974	15 to 18

[1] Of the demand and time liabilities of scheduled commercial banks.

V Lending Rates of Scheduled Commercial Banks

(i) Minimum Lending Rate (except for exempted categories)

May 30, 1973	June 1, 1973	10
Nov. 30, 1973	Dec. 1, 1973	10 to 11
July 22, 1974	July 23, 1974	11 to 12.5

(ii) Maximum Rate of Interest on Export Credit

Nov. 16, 1973	Nov. 16, 1973	7 to 8 (Preshipment and postshipment credit). 6 (Export credit on deferred payment terms).
Apr. 19, 1974	April 19, 1974	8 to 9 (Preshipment and postshipment credit). 7 (Export credit on deferred payment terms).
July 22, 1974	July 23, 1974	9 to 10.5 (Preshipment and postshipment credit).*

(iii) Rate of Interest for Food Procurement Credit

July 22, 1974	July 23, 1974	9 to 11 (Food Corporation of India) 9 to 12 (State Government/Agencies).

(iv) Minimum Rate on Bills

June 6, 1973	June 1, 1973	8
Nov. 16, 1973	Nov. 16, 1973	8 to 9
Nov. 30, 1973	Dec. 1, 1973	9 to 9.5
June 17, 1974	June 18, 1974	9.5 to 11 (Drawee Bills)
July 22, 1974	July 23, 1974	11 to 12.5 (Drawee Bills) 9.5 to 11 (Drawer Bills)

* Ref. DBOD. No. EXP. B. C. 98/C. 297 p. 74 dated 24-9-74.

With effect from Sept. 25, 1974, a ceiling rate of 11.5 per cent per annum on preshipment and postshipment credit (other than those extended on a deferred payment basis) as against 10.5 per cent, as at present, has been prescribed. It has also been decided to prescribe a ceiling rate of 8 per cent per annum on export credit on deferred payment basis instead of 7 per cent as at present.

Annexure 2.ii

Changes in Deposit Rates

Class of deposit	Percentage Rate of Interest 1-4-1973[a]	1-4-1974[a]	23-7-1974
1. Current accounts, deposits upto 14 days and deposits subject to withdrawal or repayment by notice for a period of 14 days or less	No interest except with the Prior approval of the Reserve Bank of India.		
2. Savings accounts	4.0	5.0	5.0
3. Fixed deposits			
1. 15 days to 45 days	2.75	3.0	3.0
2. 46 days to 90 days	3.25	3.5	3.5
3. 91 days to less than 6 months	4.75	5.0	5.5
4. 6 months to less than 9 months	5.25	5.5	6.0
5. 9 months to less than 1 year	5.25	6.25	7.0
6. 1 year to less 2 years	6.0	6.75	
7. 2 years and above and upto and inclusive of 3 years	7.0	7.50	8.0 (1 year and above but less than 3 years)
8. Above 3 years up to and inclusive of 5 years	7.0	7.75	9.0 (3 years and above and up to and inclusive of 5 years)
9. Above 5 years	7.25	8.0	10.0

[a] Scheduled commercial banks with demand and time liabilities upto Rs 50 crores were allowed to pay an additional interest of between 1/8 and 1/2 per cent per annum, on all classes of deposits bearing interest up to July 22, 1974. This concession has been withdrawn. However, effective July 23, 1974, banks with demand and time liabilities below Rs 10 crores are allowed to pay an additional interest of 0.5 per cent per annum on saving deposits.

3

The Reserve Bank of India as the Regulator of Bank Credit

Economic Significance of Bank Credit

The importance of currency and the relative insignificance of bank money in the conventional computation of the total money supply (currency plus demand deposits) may suggest that any restrictive action on bank credit will have an impact only on a limited portion of money supply and, therefore, monetary policy may not appear to be meaningful in an underdeveloped economy. It is quite true that this relationship between currency and bank deposits will impart an element of rigidity to monetary control. But the argument should not be pushed so far as to establish a case for the complete negation of a monetary policy in such economies. In an underdeveloped economy the institutional framework is rapidly changing and with the growing spread of bank deposits[1] as a component of total monetary resources in the wider sense of currency plus aggregate deposits, central bank action on bank credit becomes quite relevant. Indeed in some developing economies the pace of aggregate deposit expansion has actually been observed to be greater than that of currency expansion. The area of transactions amenable to monetary control becomes wider and wider, and bank credit gradually tends to assume a dominant influence on overall economic activity almost in the same manner observed in relatively maturer economies. The experience of countries like France has clearly demonstrated that credit is potentially a very powerful tool for shaping the destiny of the economy and that with the help of a credit policy it is possible to direct the growth of the economy or to retard it. Even more, it is possible to encourage specific industries selectively and discourage others according to the priorities established for the purpose. Central bank control of bank credit then becomes more meaningful.

We, therefore, propose to investigate the behavioural pattern of bank credit under the stresses and strains of the policy of rapid economic growth with a view to assessing in what manner and to what extent bank credit was applied to the

[1] See footnote 35 (Ch. 2).

priority sectors in keeping with the objectives of planned economy. Our analysis portrays distinctly how far bank credit met the demands of a developing economy. The role of the monetary system in the Plan period would be considered successful if banks had been motivated to lend an increasing proportion of a growing volume of credit to the productive and preferred sectors as contemplated in the Plans. In other words the effects of monetary policy on the availability and cost of credit, as well as on its distribution amongst different sectors, will be discussed.

Before we actually analyse the trends in bank credit, we must remember the economic significance of the distribution of the banks' assets. In this connection Professor R. S. Sayers'[2] observation is of particular significance:

> ....the banks can initiate a change in the economic situation when they exchange assets with the public....by causing the public to hold more bank money and less of certain other classes of assets, that change must inevitably force repercussions on the entire economic situation.

The essential liquidity of commercial banks is determined by the character and quality of their earning assets. Liquidity depends much on the composition of a banker's portfolio of assets which have the advantage and opportunity of shiftability, either to other banks or to the central bank or both. It is through the changes and interchanges of the portfolio of earning assets that banks make a direct contribution towards meeting the credit needs of the community.

The trend in bank credit is determined by the investment activities in the public and private sectors, industrial and agricultural production, price level, conditions of foreign trade, level of employment and the government's industrial policy. In other words, the economic activities of the government and the community directly influence the pattern of bank credit. When demand is high and there is an upswing of prices, the profit prospects appear to be bright and business men, both in agricultural and industrial sectors, feel buoyant enough to boost their investments in order to expand their business operations, or start new lines of activity. They, therefore, need more bank accommodation in times of brisk economic activities.

Credit expansion enhances the expending power of the community. It must be recalled that the creation of credit by banks is preceded by a high level of economic activity which may be caused by many complex economic and social factors. It would, therefore, be misleading to suggest that the commercial banks are primarily responsible for inflationary pressures in the price level. It does not always follow that expansion of bank credits will bring about an inflationary spiral as other factors are involved in the phenomenon. It would not, therefore, be correct to hold that control on bank credit only can direct the price trends. Admittedly, in India as an underdeveloped country "there does not exist the same, or at least to the same extent, relationship between changes in money supply and changes in credit in the short period as obtained in developed countries."[3] *Prima facie,* the factors affecting the price situation are really complex.

[2] Sayers, R. S., *Modern Banking,* Fifth Edn., Oxford University Press, London, p. 157.

[3] Sethi, J.D., *Problems of Monetary Policy in an Underdeveloped Country with special Reference to India,* Asia Publishing House, Bombay, 1961, p. 313.

II

Trends in Bank Credit in the Plan Period

During the War years advances of the scheduled banks in undivided India declined as a result of a smaller volume of international trade, Government's direct aid to industries helping the War effort and also certain Governmental restrictions. Since the cessation of the War advances have been rapidly on the increase, obviously due to increasing internal and external industrial and trading activities.

The trends in bank credit in India in the planning period fall into four rather well-marked phases; (i) a decline in the volume of bank credit in the early years of the First Plan, (ii) a rapid rise since the closing year of the First Plan, (iii) a slow rise between 1957–1959, the (iv) a sharp rise since 1960–61. The fall in the bank credit in the beginning of the First Plan reflects the impact of the restrictive monetary policy pursued by the Reserve Bank of India with the launching of the First Plan, that is, on the eve of the economy taking a definite shape in the years to come. With the raising of the bank rate and abandonment of the policy of supporting Government securities, credit became costlier and banks came to exercise greater caution in their lending policy. The decline in commodity prices which started in the first quarter of 1952 and uncertainties about business prospects because of a slump discouraged inventory building and contributed to the downward trend in bank advances. It was, therefore, not difficult for the banking system to satisfy the credit requirement out of their own funds.

The upswing in bank credit since 1955–56, the closing year of the First Plan, was caused by the improvement on the production front, the revival in the level of economic activities, rise in the volume of foreign trade, and resumption of private trade in foodgrains. The increased demand for credit was met partly out of the banks' own resources and substantially through borrowings under the Bill Market Scheme. The upward trend was maintained during the entire Second Plan period by considerable Governmental capital outlays, increase in the levels of private investment and boosting of economic activities. The credit-deposit ratio was stretched. The strains on the liquidity position of the banks forced them to unload their investments in Government securities in order to enable them to expand their credit to meet the needs of growing credit requirements in the growth-oriented economy. The increased demand for credit induced banks to attract fresh deposits by offering higher rates of interest.

During the period 1957-1959 the pace of growth of bank credit slowed down. A recession in industrial production, restrictive credit policy and adoption of selective credit control measures by the Reserve Bank of India, and steps taken to control the speculative use of bank credit must have had their influence on the slackening of credit expansion.

Ever since 1960–61 commercial bank credit has maintained an upward trend. The increasing demand for bank credit since then may be ascribed to the impact of planned economic development in the country, i.e., growth in industrial investment, rise in industrial output, higher prices of raw materials and an

increase in the number of banking institutions. In short, the recent trends in bank credit are clearly the natural concomitants of industrialisation and economic advancement. The rising trend in credit-deposit ratio from 60 in 1952 to 70.74 per cent in January 1975 reflects that the increase in the volume of deposits could not keep pace with the high level of demand for credit and the consequent growing pressure on the banking system. The upward trend in the volume of credit is indicative of the increasing level of investment in both the public and the private sectors in a planned economy. In a mature economy growth in bank credit would simultaneously be associated with the rising volume of bank deposits and, barring exceptional circumstances, the ratio would not record any significant variation. However, in India our investigation has shown that the ratio has gone up appreciably. The growth of bank credit during the Plan period on the whole synchronises with the phases of the growth of national income, trends in investment, and deficit financing.

III

Pronounced Seasonality in the Demand for Credit

The most important element in the Indian economy is the pronounced seasonality in the demand for credit. This, of course, is a phenomenon typical to an economy in which the primary sector accounts for a major share of the national product. The demand for credit, therefore, broadly follows the course of the agricultural season; the busy season extends over the postharvest trading period and roughly corresponds with the half-year commencing at the end of October. Partly due to this, a substantial proportion of exports originating from agriculture and other allied sectors, tend to be boosted in the busy season which marks the period of bank credit inflow whereas the slack season coincides with the lean season for exports as a result of which the payments position is subjected to further pressure by the seasonal outflow of bank credit. An additional element for seasonality in the demand for payments is the incidence of Government operations in terms of which Government accounts are made up in March every year—the peak period of the busy season. As may be seen from Tables 3.1 and 3.2, over the years 1948–1974 the busy season has shown a rising trend while in a slack season (with minor exceptions) contraction has been recorded.

A scrutiny of the balance sheet of banks reveals that they generally maintain excess balances over and above the statutory minimum under Section 42(1) of the Reserve Bank of India Act; fluctuations in such excess deposits of scheduled banks are an important pointer to the conditions obtaining in the money market. Broadly speaking, during the busy season (November-April) the excess balances tend to decline and bank credit and borrowings from the Reserve Bank rise. The credit-deposit ratio goes up while the investment ratio moves downward. During the slack season (May-October) excess balances increase and the picture is reversed.

Tables 3.1 and 3.2 further indicate how the gulf between the credit ratio at the

TABLE 3.1. Seasonal Ratios of Scheduled Banks, 1948-1967 (Ratio to Deposits at the End of the Season)

	Cash Ratio	*Investment Ratio*	*Credit Ratio*
Period Prior to the Plan			
Slack 1948	13	—	41
Busy 1948-49	10	—	57
Slack 1949	13	—	46
Busy 1949-50	10	—	56
Slack 1950	13	43	48
Busy 1950-51	10	35	65
Slack 1951	13	37	58
The First Plan Period			
Busy 1951-52	9	35	67
Slack 1952	11	38	54
Busy 1952-53	9	36	61
Slack 1953	11	40	53
Busy 1953-54	9	38	65
Slack 1954	11	39	58
Busy 1954-55	8	36	65
Slack 1955	9	38	58
Busy 1955-56	8	33	71
The Second Plan Period			
Slack 1956	8	34	70
Busy 1956-57	9	28	75
Slack 1957	11	29	64
Busy 1957-58	9	29	63
Slack 1958	9	39	53
Busy 1958-59	8	36	60
Slack 1959	6	44	52
Busy 1959-60	7	38	59
Slack 1960	8	36	58
Busy 1960-61	6	29	68
The Third Plan Period			
Slack 1961	7	35	68
Busy 1961-62	7	31	73
Slack 1962	6	35	68
Busy 1962-63	6	29	76
Slack 1963	8	34	66
Busy 1963-64	6	27	80
Slack 1964	6	35	67
Busy 1964-65	6	27	80
Slack 1965	7	31	72
Busy 1965-66	6	27	77
Period After The Plan			
Slack 1966	6	34	68
Busy 1966-67	6	27	77

Sources: 1. *Report on Currency and Finance*, Reserve Bank of India, 1964-65 and 1966-67, Statement 33, p. S62.
2. Other Reserve Bank of India publications.

TABLE 3.2. Seasonal Variations in Selected Items of Scheduled Commercial Banks' Liabilities and Assets

(In lakhs of rupees)

Season	*Net Demand deposits*	*Net time deposits*	*Aggregate Deposits (1+2)*	*Borrowing from Reserve Bank*	*Cash in hand and balances with the Reserve Bank*	*Cash ratio at the end of the period*	*Investment in Government Securities*	*Investments ratio at the end of the period*	*Bank credit*	*Credit deposit ratio at the end of the period*	*Finance for food procurement operations*
	1	2	3	4	5	6	7	8	9	10	11
The Fourth Plan Period											
Slack 1969	+11,506	+23,306	+34,812	− 6,744	+ 2,667	6.4	+ 20,833	26.4	+ 3,130	72.9	
Busy 1969-70	+17,189	+14,906	+32,095	+20,291	+ 776	6.2	− 10,087	22.8	+ 56,290	79.4	
Slack 1970	+17,432	+27,428	+44,860	− 8,592	+ 3,121	6.2	+ 15,524	23.8	+ 22,668	77.0	+ 3,440
Busy 1970-71	+19,022	+24,529	+43,551	+ 4,015	+ 1,234	6.0	+ 3,912	22.7	+ 39,416	78.0	+ 7,030
Slack 1971	+20,166	+42,188	+62,354	−17,205	+ 5,853	6.3	+ 20,850	23.7	+ 16,278	73.1	+15,580
Busy 1971-72	+31,016	+31,423	+62,439	+ 422	+ 1,369	6.0	+ 14,395	23.6	+ 35,495	71.7	− 7,109
Slack 1972	+26,217	+44,248	+70,464	− 1,612	+ 5,106	6.1	+ 51,941	28.1	+ 6,735	66.2	− 127
Busy 1972-73	+33,574	+47,584	+81,158	+ 1,755	+ 5,260	6.1	− 8,957	24.5	+ 89,694	70.3	+ 569
Slack 1973	+25,140	+64,736	+89,876	+ 5,617	+46,447	10.4	+ 18,679	24.1	+ 34,565	67.4	− 5,706
Busy 1973-74	+45,170	+23,110	+68,281	+25,273	−21,824	7.6	+ 7,138	23.2	+100,518	72.6	+18,869
Outstanding as on April 26, 1974	444,369	589,517	1,033 886	33,318	78,099		240,006		750,816		42,406

Source: *Report on Currency and Finance*, Reserve Bank of India, 1973-74, p. S51.

end of the slack and that in the busy seasons has been on the decline from the pre-Plan period to the Plan period. This is significant evidence of the growing pressures of bank credit in the planning era obviously for diversification of economic activities.

Continued industrialisation and increased activities of banks in financing industry is reflected in the change in the seasonal character of Indian banking. The seasonal character of bank credit has become less important as industrialisation advances and new industries develop which are not crop-based.

As the nonagricultural sector expands and bank advances against these commodities increase, they considerably moderate the seasonal variation in bank credit for agricultural commodities. The attenuation of the overall seasonal variations indicates that a large part of the increase in advances is being absorbed by the new non-agro-based industries. The credit policy of the Reserve Bank of India based on the traditional conception of the seasonal pattern of a purely agricultural economy, therefore, fails to satisfy the changing needs of a semi-industrial economy.

IV

Triple Significance of Credit-Deposit Ratio

The credit-deposit ratio of commercial banks has triple significance. Primarily, and most significantly, it is a measure of the utilisation of resources by the banking system. Conversely, it is a measure of the liquidity of the banking system. Moreover, it is an indirect but important means of monetary management by the central banking system. The actual or possible level of the credit-deposit ratio is one of the important factors which the Reserve Bank of India takes into account in formulating measures of general credit control. The rise in the credit-deposit ratio of the different categories of scheduled banks from the low levels of 35 to 50 per cent at the end of December 1946 (Indian Union Figures only), to around 72 per cent at the end of March 1975 reflects the higher level of utilisation of the resources of banks in recent years (Table 3.3). The rise in credit was sharper than the deposit expansion; hence the steep rise in the ratio.

Table 3.4 depicts a better picture of the credit-deposit ratio of the Indian banks during the pre-Plan period and the Plan period. The ratio on the pre-Plan period indicates under-utilisation of banking resources. In as many as 34 scheduled banks and 27 nonscheduled banks it was at or below 50 per cent in 1949. Of these, in 12 (7 scheduled and 5 nonscheduled) it was lower than 31 per cent. The position has consistently improved for the scheduled banks during the planned period. As compared to 34 scheduled banks in 1949 and 33 scheduled banks in 1950, hardly 7 scheduled banks had it at 50 or below at the end of 1965 and in only one of them was it below 31. Thus,the classification of banks by their credit-deposit ratio indicates an absence of lending opportunities for the banking system during the pre-Plan period. Table 3.4 reinforces the argument advanced earlier in the case of Table 3.3. As the process of development gathered

TABLE 3.3. Classification of Scheduled Banks According to Their Credit-Deposit Ratio, 1946-1975

(Credit-Deposit Ratio in Percentage)

At the end of December	*Imperial Bank of India/State Bank of India*	*Other Indian Scheduled Banks*	*Foreign Banks*
Period Prior to the Plan			
1946	35	50	39
1947	31	47	56
1948	35	47	69
1949	37	49	74
1950	44	51	77
The First Plan Period			
1951	62	61	102
1952	55	53	85
1953	51	55	79
1954	44	57	84
1955	48	60	86
The Second Plan Period			
1956	60	66	108
1957	47	61	95
1958	36	58	82
1959	29	60	76
1960	40	68	88
The Third Plan Period			
1961	48	68	90
1962	50	68	101
1963	52	69	98
1964	63	69	87
1965	71	68	68
The Fourth Plan Period			
1969-70	76.70	79.74	83.50
1970-71	85.11	79.80	83.99
1971-72	74.17	74.57	79.26
1972-73	66.52	71.69	73.96
1973-74	71.52	73.27	75.12
1974-75	65.21	72.42	71.32

Source: Compiled by the author from Reserve Bank of India publications and vide D' Mello's (S.B.I.) letter to author dated 25.11.75.

momentum with the launching of the Five Year Plans, the scope for channelising bank funds increased considerably with the result that as many as 44 scheduled banks had their ratio at 51–70 per cent and 17 at 71–100 per cent in 1965. The rise in ratio is due to the undertaking of new and challenging functions by the banking system in the changing economic situation.

At the other extreme, the credit-deposit ratio of 30 scheduled and 276 nonscheduled banks was at or above 70 per cent in 1949. Of these 17 scheduled and 167 nonscheduled banks had their ratio above 100 per cent. In other words,

TABLE 3.4 Classification of Banks by Their Credit-Deposit Ratio (Frequency Distribution) 1949-1965

(As on the last Friday)

Year	Less than 31 Percent		31-50 Percent		51-70 Percent		71-100 Percent		100 Percent and above	
	No. of Scheduled banks	No. of non-scheduled banks	No. of scheduled banks	No. of non-scheduled banks	No. of scheduled banks	No. of non-scheduled banks	No. of scheduled banks	No. of non-scheduled banks	No. of scheduled banks	No. of non-scheduled banks
Period Prior to the Plan										
1949	7	5	27	22	26	41	13	109	17	167
1950	4	7	29	23	26	33	18	117	14	159
The First Plan Period										
1951	2	7	14	15	33	37	26	112	17	135
1952	1	11	12	14	44	50	22	164	13	186
1953	–	12	12	12	42	54	21	153	14	184
1954	1	11	19	21	42	79	14	134	12	156
1955	3	14	18	26	43	106	11	102	14	139
The Second Plan Period										
1956	1	13	12	24	39	85	21	111	16	121
1957	3	13	16	19	45	79	14	104	13	103
1958	4	11	21	18	43	79	15	103	10	81
1959	3	10	15	22	47	88	24	90	5	59
1960	3	9	14	27	52	97	14	68	10	57
The Third Plan Period (Four years only)										
1961	3	5	17	24	39	64	15	72	8	57
1962	1	7	18	37	43	79	9	39	9	50
1963	–	12	14	35	41	62	13	30	11	51
1964	–	28	10	11	34	34	23	17	9	25
1965	1	2	6	8	44	17	17	3	8	3

Sources: Compiled by the author from:
Reserve Bank of India, *Statistical Tables relating to Banks in India 1965* (Table 13, p. 34) and other various Reserve Bank publications.

only 33 per cent (30 out of 90) of the scheduled banks had a credit ratio above 70 per cent while as many as 80 per cent of nonscheduled banks had such high ratios (Table 3.4). This was a clear case of the overextended position of a large number of nonscheduled banks who had commitments much beyond their capacity. This was also an indication of a very small deposit base of the nonscheduled banks. Apart from their high ratio, their advances portfolio was of extremely poor quality. The operational behaviour of these 'sickly' units did not contribute anything to economic efficiency and financial integrity. In order to mitigate the structural weakness of the banking system, the weak units have been eliminated and the number of nonscheduled banks has come down markedly—from 256 in 1960–61 to as few as 9 in July 1974.[4]

To bring the matter into better focus, it is necessary to bring out the differences in the ratio of bank credit to deposit between Indian and foreign banks. The foreign banks are the strongest banks in India and have the highest ratio as shown in Table 3.3. It is well-known that for some foreign banks the upper limit of loans is determined by the level of demand rather than by a conventional consideration of liquidity and solvency. It has to be remembered that they have the ability to borrow from sources other than those of the Indian system to maintain their reserve requirements. They can, and do, borrow from their headquarters primarily in the London money market during periods of restrictive credit policy. Thus, they do not feel the effects of changes in interest rates directly and can transmit the effects of changes in India abroad and *vice versa*. They, therefore, do not expand their credit just on the basis of deposits in India.[5]

It is widely recognised that foreign banks possess high prestige and reputation. Varied experience and wide contacts afford the foreign banks a competitive advantage over the Indian banks; therefore, the chance of runs on them is slender. This very feeling of safety and security enables them to operate with low secondary reserves and lower cash ratios. Furthermore, they have an almost exclusive preserve of business of foreign bills. Since these bills are short-term and self liquidating, banks dealing in them can afford to maintain lower cash reserves.

In recent years the average credit-deposit ratio of the foreign banks has however come down (Table 3.3) in response to the increasingly tight monetary policies and the number of scheduled banks showing the credit-deposit ratio above 100 per cent has declined (Table 3.4). Banks with their credit-deposit ratio between 71–100 per cent consist of the foreign as well as some of the leading Indian banks. In the case of the Indian banks, the high credit-deposit ratio is an indication of the extensive business commitments they have made.

In any case, all these different explanations of the varying levels of the credit-deposit ratio merely underline the fact that the banks are not self-reliant and have to lean heavily on interbank call loans and Reserve Bank borrowings in order to supplement their own deposits and other liabilities particularly during the busy season.

[4] *Reserve Bank of India Bulletin*, March, 1975, S. 236.

[5] Rosen, George, *Some Aspects of Industrial Finance in India*, Asia Publishing House, Bombay, 1962, pp. 19–20.

Among the larger banks the State Bank of India normally maintains a lower ratio in comparison with other banks (Table 3.3). The credit-deposit ratio of the old Imperial Bank reflected the greater conservatism in the past. In fact, it is also true that the State Bank of India's great financial stability and enviable position in the money market enables it to be very selective in its choice of borrowers. It is also possible that since it is a state-owned bank, there has been a shift in policy in recent years to invest a considerable portion of its resources in Government securities even at the cost of prospective profits.

The State Bank of India (being the only bank in the public sector before July 1969) along with the Reserve Bank of India is expected to follow monetary policy with greater sincerity, and they both ought to give greater assurance to the Government that their debt floatations will be adequately subscribed. However, the State Bank has also been following a policy of branch expansion in unremunerative areas, and a credit-worthy clientele has not yet fully emerged in these new areas which naturally limits the span of credit creation.

In recent years the credit ratio has gone up marking a distinct trend from the past inasmuch as some innovations have been effected in its operational pattern by way of response to the resource demands of the rural sector. The rising ratio also indicates its larger lending operations to meet the growing demands of both the public and private sectors in the Third and Fourth Plan periods.

V

Significant Shifts in the Direction of Bank Credit

The important changes that have taken place in the economy in the planned period are reflected not only in the steady upward trend in bank credit, but also in the significant shifts that are noticeable in the direction of bank credit. A striking feature of the trends in commercial bank credit in recent years is the more or less steady rise in the proportion of advances to industry as against commerce.

In the decade 1951–1961, the share of industry in total scheduled bank advances increased from 33.6 to 52.7 per cent while that of commerce and trade declined from 53.1 of the total in 1951 to 31.3 per cent in 1961 (Table 3.5). The attraction of a greater volume of bank funds by industry and the relative decline of trade and commerce in this matter is an index of the industrial growth of the economy. The concentration of investment in the industrial sector, in which the risk element is less, is characteristic of the investment pattern in developing economies. Hence the fact that industry has been able to attract an increasing proportion of total bank advances may be taken as indicative of industrial development of the country's economy (Table 3.5 and 3.6).

Between April 1961 and March 1965 the proportion of bank credit going to the industrial sector went up from 52.7 to 61.5 per cent while the share of commerce came down from 31.3 to 25.6 per cent. Bank advances to industry improved by 17 per cent to Rs. 1287 crores in 1965 over the year 1964. The other sectors have more or less retained their respective positions. Within the industrial sector,

TABLE 3.5. Distribution of Scheduled Bank Advances to Industry and Trade 1951-1965

(Amounts in crores of rupees)

	March 1951 (*commencement of the First Plan*)		*March* 1956 (*commencement of the Second Plan*)		*April* 1961 (*commencement of the Third Plan*)		*March* 1965	
	Amount	*Percentage of total bank credit*	*Amount*	*Percentage of total bank credit*	*Amount*	*Percentage of total bank credit*	*Amount*	*Percentage of total bank credit*
Advances to Industry	196.1	33.6	278.5	36.2	687.8	52.7	1,287.3	61.5
of which to:								
(a) Cotton textiles	52.8	9.0	62.7	8.1	145.1	11.1	247.2	11.8
(b) Jute	23.7	4.1	23.1	3.0	32.1	2.5	66.1	3.2
(c) Sugar	34.4	5.9	48.8	6.3	100.8	7.7	99.8	4.8
(d) Iron & Steel	6.5	1.1	7.7	1.0	33.9	2.6	39.5	1.9
(e) Engineering	11.6	2.0	32.9	4.3	109.6	8.4	304.5	14.5
(f) Chemicals	N.A.	N.A.	10.3	1.3	33.0	2.5	41.1	2.0
(g) Cement	1.3	0.2	2.5	0.3	18.5	1.4	21.9	1.0
Advances to Trade and Commerce	310.2	53.2	388.1	50.4	408.4	31.3	536.8	25.6
Total Bank Credit	584.6	100.0	770.2	100.0	1,306.2	100.0	2,094.7	100.0

N.A.=Not available.

Source: *Reserve Bank of India Bulletin*, April 1966, p. 348.

TABLE 3.6. Advances of Scheduled Banks according to Purpose 1963, 1964 and 1965 (Second year, Third year and Fourth year of the Third Five Year Plan)

(Amounts in crores of rupees)

	March 31, 1963			*March 31, 1964*			*March 31, 1965*		
*Number of Reporting Banks**	77			75			75		
	Number of Accounts	*Amount*	*Percentage*	*Number of Accounts*	*Amount*	*Percentage*	*Number of Accounts*	*Amount*	*Percentage*
1. Industry	43,880	921.24	57.2	53,859	1,104.40	59.2	48,328	1,287.32	61.5
2. Commerce	175,489	443.95	27.6	197,366	486.83	26.1	174,124	536.78	25.6
3. Financial	18,225	84.08	5.2	16,365	99.19	5.3	15,340	94.23*	4.5
4. Agriculture	50,194	4.09	0.3	120,870	8.69	0.4	57,808	3.95	0.2
5. Personal	633,830	99.22	6.1	595,742	101.77	5.5	728,206	109.22	5.2
6. Professional	48,996	12.46	0.8	17,919	12.23	0.7	18,653	13.19	0.6
7. All others	58,227	45.66	2.8	51,408	51.65	2.8	83,938	50.05	2.4
8. TOTAL	1,028,841	1,610.70	100.0	1,053,529	1,864.75	100.0	1,126,397	2,094.74	100.0

* Adjusted to include 'due from banks' with a view to making the figures comparable with earlier years.

Source: *Trend and Progress of Banking in India*, Reserve Bank of India, 1965, p. 12.

the engineering and cotton textile industries have secured the largest share of bank credit. The share of the former in the group total went up from 8.4 to 14.5 per cent while that of the latter from 11.1 to 11.8 per cent during the period 1961–1965 (Table 3.5).

The results of the purposewise survey of scheduled banks' advances as on March 31, 1966, at the end of the Third Plan, show that their advances at Rs 2347 crores were higher by Rs 252 crores as compared with the previous year (Tables 3.6 and 3.7). Of the rise of Rs 252 crores in total advances, as much as Rs 223 crores was on account of industry representing an incremental ratio of industrial advances of 88.5 per cent. In keeping with the growing pace of industrial development, this ratio rose from 65.6 per cent during 1962-63 to 88.5 per cent in 1965–66 and for the Third Plan period as a whole works out to 79.0 per cent.[6] Table 3.7 shows in summary form the breakdown of advances on a sectorwise basis. It will be seen that industrial advances formed 64.3 per cent, over three fifths, of the total bank credit at the end of March 1966 compared with 61.5 per cent in 1965. Next to industry, commerce accounted for nearly one fourth of the total advances although its share at 24.4 per cent of the total advances was slightly smaller as compared to 25.6 per cent in 1965.

TABLE 3.7. Sectorwise Classification of Advances of Scheduled Banks[1]

(Amount in crores of rupees)

	March 1966 *(End of the Third Plan)* *Amount*	*Percentage to total*
1. Industry	1,510	64.3
2. Commerce	573	24.4
3. Financial Institutions	77	3.3
4. Agriculture	5	0.2
5. Personal	108	4.6
6. Professional	13	0.6
7. All others	61	2.6
	2,347	100

[1] Figures may not add up to the total due to rounding up of figures.
Source: *Reserve Bank of India Bulletin*, January 1967, p. 68.

As in 1965, a substantial share (Rs 406 crores) went to the textile industry, accounting for over one fourth of Rs 1,510 crores—the total advances to industry. In the textile group itself, over two thirds (69.9 per cent) of the advances was accounted for by the cotton textile industry and at Rs 284 crores they were higher by Rs 37 crores over the previous year and accounted for over 12 per cent of the total bank credit (Table 3.8). Advances to the engineering industry showed a rise of Rs 71 crores in 1966 against a rise of Rs 65 crores in the previous year. At Rs 375 crores they formed about one fourth of the advances to industry and

[6] *Reserve Bank of India Bulletin*, January 1967, p. 68.

16 per cent of the total bank credit. This rise of Rs 71 crores was equally divided between the heavy and light engineering groups. A rise was also recorded in 1966 in the advances to iron and steel (Rs 36 crores), sugar (Rs 23 crores), chemicals (Rs 7 crores), cement (Rs 6 crores) and paper and paper products (Rs 6 crores) over the year 1965.

Thus, an interesting feature revealed is that the industries claiming a major share of bank credit (Table 3.8 marked with an asterisk) are closely associated with the industrial development programme of the Five Year Plans. Table 3.8 speaks for itself and shows that all the industries which improved were accorded comparatively high priorities in the Second and Third Five Year Plans as compared to those which had slipped or barely maintained their relative positions. As for iron and steel and the engineering industry, it is to be noted that bank credit was necessitated by the expansion of the iron and steel industry in the private sector and the growing financial requirements of the trade in marketing the iron and steel produced by the public sector steel plants.

The changing pattern of bank advances with regard to purpose is a facet of the shift in general emphasis of banking from commerce to industry, particularly the new industries, in the context of acceleration of investment and diversification. An analysis of the changes in the distribution of bank credit among various sectors of the economy shows that the rising share of the industrial as against the commercial sector bears the impress of rapid industrial advance within the economy. The old traditional industries, like cotton textiles etc., and the new and fast growing basic industries like engineering, cement, chemicals, and iron and steel claimed a substantial share. A sharp turn in favour of the industrial sector took place from 1956, with a steep rise in investment in the Second Plan period. In short, the changing pattern of bank advances reflects the changing composition of economic activity in India, and the growing importance of industry in the national economy is reflected in the dominance of industrial advances in the total advances of scheduled banks.

India being essentially an agricultural country, the importance of agriculture to national income needs no emphasis and the niggardly treatment meted out to it by banks should be deplored. It is unfortunate that agriculture (including cottage and small-scale sector) has not been able to attract a flow of bank funds. Commercial banking has failed to provide financial assistance to this sector. The attitude of commercial banks cannot, however, be attributed exclusively to their conservatism or adherence to traditional principles of banking. In fact, the development of banking and economic advancement is interdependent; they go together and help each other. In India, agriculture has failed to attract the attention of commercial banks because of the general backwardness of the economy, the low standard of literacy of the rural people, the absence of a practice of keeping proper accounts, inadequacy of marketing and warehousing facilities, the absence of security, and the existence of a considerable element of risk in agriculture and agro-industries. The fact that commercial bank credit moves rather sluggishly into the agricultural sector may be due to a number of reasons such as the lack of an efficient organisation linking the borrower-lender, or the absence of a sufficient number of credit-worthy borrowers, or low

TABLE 3.8. Industrywise Classification of Advances of Scheduled Banks, 1964-1966 (Last Three Years of the Third Plan)

(Amount in lakhs of rupees)

	March 31, 1964			*March 31, 1965*			*March 31, 1966*		
	Number of Accounts	*Amount*	*Percentage to total*	*Number of Accounts*	*Amount*	*Percentage to total*	*Number of Accounts*	*Amount*	*Percentage to total*
	1	2	3	4	5	6	7	8	9
Number of Reporting Banks		75			75			75	
Industry									
*1. Cotton Textiles (ginning, pressing, spinning, weaving, etc.)	9,752	22,593	12.1	5,757	24,724	11.8	6,163	28,437	12.1
2. Jute Textiles	187	6,469	3.5	260	6,610	3.2	250	6,246	2.7
3. Rayon, Nylon & Silk Textiles	1,894	2,586	1.4	1,530	2,925	1.4	1,524	2,908	1.2
4. Other Textiles	2,779	2,378	1.3	1,868	2,772	1.3	1,722	3,070	1.3
*5. Iron & Steel	1,686	3,216	1.7	2,039	3,954	1.9	2,349	7,546	3.2
6. Non-ferrous Metals	667	1,111	0.6	622	1,200	0.6	765	1,633	0.7
7. Coal Mining	376	1,340	0.7	358	2,327	1.1	361	2,488	1.1
8. Other Mining and Quarrying	418	1,041	0.6	419	1,094	0.5	365	1,276	0.5
*9. Engineering	8,931	23,922	12.9	10,319	30,449	14.5	10,884	37,533	16.0
i) Heavy Engineering	1,643	12,002	6.4	1,875	16,144	7.7	2,254	20,022	8.5
(a) Heavy Machinery	383	5,246	2.8	487	8,107	3.9	431	10,021	4.3
(b) Motor Vehicles & Ancillaries	395	3,413	1.8	290	3,191	1.5	339	3,740	1.6
(c) Electrical Machinery	181	1,228	0.7	215	1,931	0.9	240	2,517	1.1
(d) Others	684	2,115	1.1	883	2,915	1.4	1,244	3,744	7.4
ii) Light Engineering	7,288	11,920	6.5	8,444	14,305	6.8	8,630	17,511	7.4
(a) Wire & Wire Products	673	1,142	0.6	773	1,673	0.8	815	1,977	0.8
(b) Bicycles & Parts	690	904	0.5	797	872	0.4	632	1,111	0.5

TABLE 3.8—*Continued*

	1	2	3	4	5	6	7	8	9
(c) Concerns producing Electrical goods & accessories	1,333	3,300	1.8	1,354	3,995	1.9	1,430	4,809	2.0
(d) Sewing Machines	138	503	0.3	155	382	0.2	155	445	0.2
(e) Others	4,454	6,071	3.3	5,365	7,383	3.5	5,598	9,169	3.9
*10. Sugar	598	7,622	4.1	487	9,982	4.8	558	12,252	5.2
11. Gur	—	—	—	33	85	—	62	44	—
12. Vegetable Oil Crushing & Refining (excluding Vanaspati, Soap, etc.)	4,234	3,739	2.0	2,167	2,950	1.4	1,871	3,113	1.3
13. Vanaspati	—	—	—	130	593	0.3	156	844	0.4
*14. Chemicals and Dyes	974	3,686	2.0	1,086	4,113	2.0	1,358	4,853	2.1
15. Drugs & Pharmaceuticals	1,008	2,111	1.1	664	2,250	1.1	801	2,762	1.2
16. Fertilisers	127	896	0.5	142	907	0.4	198	1,285	0.5
17. Plastics (Polyethylene, P. V. C. Polystyrene & Others)	427	508	0.3	423	528	0.3	569	724	0.3
18. Paints & Varnishes	239	292	0.2	258	442	0.2	309	548	0.2
*19. Cement	120	2,384	1.3	124	2,187	1.0	127	2,754	1.2
20. Public Utilities	3,708	3,789	2.1	3,631	4,239	2.0	3,527	4,488	1.9
i) Transport Industry	3,468	2,493	1.4	3,435	2,450	1.2	3,166	2,499	1.1
(a) Motor Transport	3,064	1,824	1.0	3,108	1,829	0.9	2,867	1,973	0.9
(b) Others	404	669	0.4	327	621	0.3	299	526	0.2
ii) Electricity (Generation & distribution)	53	1,082	0.6	68	1,119	0.5	73	1,267	0.5
iii) All Others	187	214	0.1	128	670	0.3	288	722	0.3
*21. Paper & Paper products	1,279	2,360	1.3	1,371	3,206	1.5	888	3,845	1.6
22. Rubber Products	1,203	2,097	1.1	395	1,836	0.9	492	1,981	0.9
23. Leather & Leather Goods	496	460	0.2	536	510	0.2	570	569	0.2
24. Fuel Oil	248	2,115	1.1	546	2,876	1.4	118	2,363	1.0

TABLE 3.8—*Continued*

	1	2	3	4	5	6	7	8	9
25. Plantations	2,357	4,410	2.3	3,290	5,431	2.6	1,910	5,189	2.2
i) Tea	782	2,866	1.5	790	3,574	1.7	797	3,535	1.5
ii) Coffee	691	785	0.4	647	587	0.3	542	230	0.1
iii) Rubber	79	27	—	31	274	0.1	28	184	0.1
iv) Cashew	403	599	0.3	279	755	0.4	343	711	0.3
v) All Others	150	133	0.1	1,543	241	0.1	200	529	0.3
26. Glass and Glassware	252	496	0.3	346	656	0.3	287	784	0.3
27. Hotels	—	—	—	—	—	—	1,363	406	0.2
28. Others	10,151	8,815	4.7	9,527	9,885	4.8	9,798	11,038	4.7
TOTAL	53,859	110,440	59.2	48,328	128,732	61.5	49,345	150,979	64.3

* See p. 75

Source: *Reserve Bank of India Bulletin*, January 1967, pp. 69–70.

average profit expectations with larger uncertainties of income etc. It may be possible to induce banks to move into this type of business to an increasing extent by offering to share higher costs or even losses. An all out effort should be made to remove the organisational deficiencies in these sectors.[7] In a scheme of planned economic development the Reserve Bank of India should pay more attention and adopt adequate measures to direct the flow of bank credit into these important sectors of the economy. It is a happy augury that there has been a liberal change in the central banking credit policy in this direction since the nationalisation of the major commercial banks. One of the principal objectives of bank nationalisation is to direct bank credit to agriculture and the hitherto neglected segments of society (see Chapter 13).

VI

Securitywise Composition of Credit

Unsecured loans in India have not gained popularity because of the lack of credit information centres like Dun and Bradstreet, the Rovert Morris Associates etc. Centralisation of decision borrowed from the principles of British banking goes against the policy of the Personal Loan System which, however, should be made popular in India in order to introduce the diversified business elements in a developing economy.

The increasing proportion of advances against nonagricultural commodities (Table 3.9) testifies to the importance of new industries. Changes in the distribution of bank credit by the type of security are governed, not only by basic economic trends, but also by the operation of selective credit controls which seek to regulate the flow of bank credit to various sectors. Commodities subject to almost continuous control were foodgrains and oilseeds. At one time or another, less stringent restrictions were imposed also on advances against raw cotton, sugar, textiles, shares, jute and clean advances. On the whole, agricultural goods have been subjected to a larger degree of restraint.

Table 3.10 brings out the position of scheduled commercial banks' advances according to security for the years 1966 and 1967.

It is thus evident from Table 3.10 that over four fifths of bank credit in India is on a secured basis, that is it is made against tangible security. Data on the composition of advances on the basis of security (Tables 3.9 and 3.10) reveal that the share of advances against agricultural commodities declined but that of advances against 'manufactures' increased indicating India's onward march towards industrialisation in the planning era.

There are differences between Indian banks and foreign banks in the distribution of their credit among broad sectoral groups. A far greater proportion of the total credit of the foreign banks was against plantation products, the absolute volume being as large as that of Indian banks. A large proportion of industrial credit was against jute, chemical and rubber products, almost equal

[7] Sen, S. N., op. cit., pp. 289–90.

TABLE 3.9. Securitywise Classification of Scheduled Banks Advances 1957 and 1962

(Amount in crores of rupees)

	1957		1962		Percentage increase 1962 over 1957
	Amount	Percentage to total advances	Amount	Percentage to total advances	
Security for Advances					
Agricultural	166	19	251	18	51
Nonagricultural	529	62	970	68	83
(a) Manufactures and minerals	270	32	540	38	100
(b) Assets of industrial Concerns[1]	33	4	76	5	130
Total secured advances	695	81	1,221	86	76
Unsecured advances	162	19	199	14	23
Total Advances	857	100	1,420	100	66

[1]Other than real estate and financial assets.

Source: Crick, W. F., Ed., *Commonwealth Banking Systems*, Clarendon Press, Oxford, 1965, p. 209.

TABLE 3.10. Classification of Scheduled Commercial Banks Advances According to Security, 1966-1967

(In crores of rupees)

	Outstanding as on the last Friday of	
	April 1966	April 1967
Seasonal Advances (Paddy and Rice, Wheat, Other Foodgrains, Sugar and Gur, Groundnuts, Cotton and Kapas, Raw Jute, Tea and others)	513.79	480.82
Nonseasonal Advances	1,498.25	1,851.11
(a) Manufactures and Minerals (Cotton Textiles, Jute Textiles, Iron & Steel and Engineering Products and others)		
(b) Others (Shares and Debentures of Joint Stock Companies, Government and other Trustee securities, Gold & Silver Bullion & ornaments and Assets of Industrial concerns)		
Total Secured Advances	2,012.04	2,331.93
Total Unsecured Advances	318.18	337.40

Sources: *Report on Currency and Finance*, Reserve Bank of India, 1966-67, Statement 29, p. S50–51.

again in absolute volume as that of Indian banks, and a larger proportion was against iron and steel and other metal products, this being much lower absolutely than that of Indian banks. Indian banks almost had a monopoly of advances against sugar and a very considerable proportion of the total advances against cotton textiles, real estate, gold and silver, fixed deposits and Government securities.[8]

From the preceding discussion, it is obvious that the greater interest of foreign

[8] Rosen, George, op. cit., p. 28.

banks lies in financing those industries in which foreign investment is high, such as plantation products and jute. They have exhibited less interest in the financing of newer Indian owned industries and in personal advances. They play an important part in the financing of imports like iron and steel and chemical products mainly because of their connections with the importing countries and partly because of their tradition and experience.[9]

VII

Inventory Sales Ratio and Bank Borrowing Inventory Ratio

Cash credits form about 80 per cent of the total bank credit in India.[10] In an era of planned economic development, it is curious to note that the methods and procedures of bank lending in India are still based on the earlier naive version of the real bills doctrine. The 'self-liquidating assets' concept suited the times in which it arose but the traditional attitude of the British bankers has changed in several aspects now. The nature of the security is not regarded as determining the nature of the advance. Professor R. S. Sayers[11] sums up the position of the present day British banker as one in which the banker

> will lend the required sum; and will take what collateral security the client can conveniently offer without worrying greatly about the relations between the sum to be borrowed and the market value of the collateral. He concludes: in general we may say that rising security values will not automatically make bank loans much easier to obtain than they were before, and that falling security values will not make bank loans much less available than before.

In the changing situation, the structure of the economy is transforming in favour of nonseasonal industry. Bank lending operations, too, need be channelised towards industrial purposes in the altered perspective.

The cash credit system in India is based on the theory that security measures the need for credit, and it has a preference for inefficient units. The efficiency of a manufacturer is judged by his low inventory-sales ratio. In the system where inventories determine the credit needs, the progressive industries which have a low inventory-sales ratio would get little financing facilities.[12] The impressive rise in bank credit to engineering industries (Tables 3.5 and 3.8) does not contradict this hypothesis. The rise in bank credit to this group of industry is, rather, an indication that this industry is of a rudimentary type and its stock of scarce raw materials, particularly iron and steel, is large.[13]

Security, in fact, does not measure the need for credit nor even the capacity

[9] Ibid., p. 29.

[10] Auburn, H. W., Ed., *Comparative Banking*, Waterlow & Sons Ltd., Third Edn., England, 1966, p. 81.

[11] Sayers, R. S., *Modern Banking*, Oxford University Press, 1954, pp. 304–6.

[12] Krishnamurthy, K. and Sastry, "Bank Loans, Short-term Rate of Interest and Manufacturers, Inventories in India, 1950–1962," *The Indian Economic Review*, Vol. 1 (New Series), No. 2, October 1966, pp. 42–55, Institute of Economic Growth, Delhi, p. 12.

[13] Report of the Board of Directors of the Industrial Development Bank of India, 1964–65, p. 20.

of industrial borrowers to repay. In the present circumstances bank credit must be prevented from being used for speculative purposes or for accumulating unnecessarily large inventories. New methods and procedures of bank lending based on discretion and rational standards, getting away from the systems based on the rules of the real bills doctrine, must be devised and the need is really urgent. With the economic and technical progress, as also the improvement of the techniques of economic management and credit investigation methods, the importance of security should decline. Credit should be extended more on the basis of creditworthiness of the borrowers than on bankable assets. Dr Hester argues that centralisation of decision making and inadequate credit investigation by Indian banks is the effect of the reliance on security. Credit investigation by Indian banks must be comprehensive and refined as in the American countries.[14] Inventories constitute the main item of current assets generally financed by banks. In recent years the private sector appears to have accumulated inventories in excess of its turnover planning. An analysis of the balance sheets of about 300 companies for 1974–75 suggests a higher piling up of inventories in relation to the annual turnover.[15] This means a larger flow of bank credit to the private sector during 1974–75, for in the absence of any sectorwise data on bank credit, the rise or fall in the inventory-sales ratio provides the clue of a possible increase or decrease in bank credit. Inventory, in a broad sense, could be defined as an idle resource of an enterprise. Efficient operation calls for a system of inventory control that will maintain the stocks at as minimum a safe level as possible. Introduction of a proper inventory control system ensures availability of materials and provides adequate protection against uncertainties of supplies. The inventory-sales ratio is, theoretically, the number of times the stock is sold and replaced during the accounting period. This ratio shows the frequency with which stocks move through the business during any year. Generally a ratio of 1 : 4 is considered good for a manufacturing sector.

The trend in bank credit as reflected in the inventory-sales ratio suggests that cotton and other textiles, sugar, plantations, cement, paper and paper products had to keep a buffer inventory during 1974–75 necessitating heavy bank credit. In the case of four out of the eleven industries for which data are presented in Table 3.11, the inventory sales ratio in 1974–75 was more than the average of 33.8 per cent and in the case of nine industries the ratio was substantially higher when compared to the generally accepted norm of 1:4.

A comparative picture of total bank credit as a percentage of inventory for selected industries is given in Table 3.12. It is evident from this table that there was a continuous fall in the ratio of bank borrowings to inventories from 64.2 per cent in 1969–70 to 49.9 per cent in 1974–75 for all industries. Almost all industrial groups have also depicted the same falling trend in this ratio.

There is vast scope to curtail excess inventory. On the basis of the accepted norm of 25 per cent a minimum of Rs 244 crores per annum could have been saved in the case of public limited companies alone. Further the interest burden

[14] Hester, D. D., *Indian Banks—Their Portfolios, Profits and Policy*, University of Bombay, 1964, p. 28.

[15] *Economic Times*, July 19, 1975.

of the bank credit at a rate of 12 per cent could also have been saved to improve efficiency and profitability.

TABLE 3.11. Industrywise Inventory-Sales Ratio, 1969-70–1974-75

Industry	*1969-70*		*1970-71*		*1971-72*		*1972-73*		*1973-74*		*1974-75*	
	a	*b*	*a*	*b*	*a*	*b*	*a*	*b*	*a*	*b*	*a*	*b*
Cement	6.7	29.1	7.1	32.0	7.7	32.9	7.8	34.8	9.3	38.9	7.9	34.9
Chemicals and Pharmaceuticals	13.1	28.2	12.5	29.1	12.3	28.9	11.4	28.3	5.7	27.7	11.2	28.1
Cotton Textiles	15.9	30.2	16.9	30.4	18.1	31.6	14.9	30.2	15.6	33.9	18.9	36.0
Engineering	16.4	40.4	15.9	39.5	16.2	40.2	16.1	39.4	14.6	38.9	17.1	24.7
Jute Textiles	11.8	28.2	14.2	32.6	12.5	28.2	12.0	25.6	12.7	27.1	10.5	28.8
Other Textiles	11.6	25.8	10.1	23.5	10.2	25.5	10.7	24.6	9.7	25.1	14.7	32.3
Paper and Paper products	4.9	29.7	4.5	29.1	12.6	30.1	4.7	32.7	4.4	32.5	5.2	32.4
Plantations	23.5	29.8	26.9	32.6	23.9	29.6	22.2	29.2	23.6	30.7	23.3	36.3
Rubber Goods	8.6	24.8	7.8	25.7	8.8	26.4	8.0	26.5	8.4	26.3	8.8	25.5
Sugar	47.6	56.9	66.0	76.7	48.4	57.8	24.8	33.6	26.4	35.3	30.5	39.5
Others	17.5	21.9	16.1	20.8	19.7	22.1	16.7	21.7	17.8	22.8	12.5	29.0
Total for all public limited companies	15.5	31.5	15.5	32.0	15.6	32.5	13.8	30.9	13.0	32.2	15.4	33.8

(*a*) Finished goods as percentage of sales. (*b*) Inventory as percentage of sales.
Source: *The Economic Times*, July 19, 1975.

TABLE 3.12. Industrywise Bank Borrowings-Inventory Ratio, 1969-70–1974-75

Industry	*1969-70*	*1970-71*	*1971-72*	*1972-73*	*1973-74*	*1974-75*
Cement	57.2	47.4	44.4	39.8	30.0	31.6
Chemicals and Pharmaceuticals	63.5	61.8	57.0	50.1	50.0	52.8
Cotton Textiles	74.3	71.9	69.7	60.5	40.4	40.4
Engineering	66.0	62.4	57.7	56.3	60.9	53.2
Jute Textiles	81.2	79.5	68.8	67.2	69.3	59.6
Other Textiles	53.6	52.0	44.7	27.4	65.0	54.2
Paper & Paper Products	77.0	57.3	51.8	56.6	68.6	51.0
Plantations	42.0	49.9	61.0	64.4	64.0	45.8
Rubber Goods	43.4	45.6	48.6	31.0	47.4	43.9
Sugar	67.8	74.4	69.4	53.0	68.5	66.9
Others	48.1	61.2	51.5	48.9	51.0	50.7
Total for all public limited companies	64.2	61.1	58.8	54.0	53.0	49.9

Source: As in Table 3.11.

VIII

Regional Disparities

Crude evidence is available which proves that big business complexes have a

complete hold on the commercial banks of the country in the matter of getting credit. The Mahalanobis Committee rightly pointed out that the criterion of security to measure the creditworthiness of the borrower tends to support the large and established enterprise against the small and struggling entrepreneur, and thus helps increase the degree of industrial concentration in the private sector of the economy. This is not healthy for an orderly growth of economy. At present, bank credit and credit granted by the privately managed Non-banking Financial Intermediaries do not form an integral part of the plan and are left to the considerations of profitability. Bank credit under these circumstances goes largely to the big borrowers, especially in a policy of credit squeeze, on considerations of profitability, stability, and safety. Small-scale industries have been assigned a distinct role in the programme of economic development in the Five Year Plans. It would, therefore, be wrong to term Indian monetary policy as realistic and positive if adequate bank finance is not made available to this vital sector. It is, indeed, significant that the philosophy of social control and bank nationalisation contemplates purposive direction of bank credit to this priority sector.

The fact that about two-thirds of the total scheduled bank credit is accounted for by 650 accounts has brought to the fore the question of rational allocation of available financial resources of the banking system.[16] Dr Hazari in a Report[17] to the Planning Commission concludes that four big business houses account for over a fifth of the total industrial investment authorised between 1959 and 1966. Of these four, Birlas took the lion's share—almost twice as much as the other three put together. He argues that top business houses with larger resources should reduce their demands on the public's savings so that more funds can be earmarked for the smaller groups of industrial houses and new entrepreneurship. Large firms with large current assets are regarded as deserving of more bank credit. The single criterion of security to measure the credit needs, as well as repaying capacity, tends to make credit particularly susceptible to this danger. The system which estimates credit requirements on the basis of the specific use to which it will be put, is likely to lead to a wider and more rational allocation of bank credit in a growth-oriented economy.

One of the causes of the present-day dissatisfaction and tension is due to the uneven spread of the development process. Not all sections of the community and not all parts of the country have a sense of participation in the process of development. The concentration of bank credit in a few major States is the antithesis of the national development policy and goes against the philosophy of decentralised industrial development. A study of this concentration of credit brings out the intricacies of the working of a mixed economy subjected to democratic planned economic growth. It is needless to point out that the inter-regional disparities in the distribution of credit go counter to the premises of balanced economic growth. Complaints that the western States like Maharashtra and

[16] *State Bank of India Monthly Review*, September 1966, Volume V, Number 9.

[17] Hazari, R. K., *Report on Planning and Industrial Licensing*, submitted to the Planning Commission in September 1967 (vide the *Statesman*, Calcutta, Saturday, September 16, 1967).

Gujarat have occupied a privileged position in the matter of bank credit at the hands of the public sector banks as against the eastern States like West Bengal, Assam etc., although deposit mobilisation has progressed at a much faster rate in the latter States, should be seriously looked into as they go against social justice and balanced regional growth.

IX

Recent Credit Trends and Inflationary Price Situation

The Reserve Bank of India has been under pressure from two opposite directions. On the one hand there is an inflationary price situation, an unusual rate of increase in money supply, a high level of deficit financing, and on the other, the business community has found it increasingly difficult to meet their credit needs even for *bonafide* purposes from their own bankers because commercial banks themselves have come under severe pressure in regard to their resources. Even the demand for credit for productive purposes could not be met.

At the beginning of the busy season in 1973–74 the cash ratio of banks was raised from 3 to 7 per cent and the statutory liquidity ratio (SLR) of holding Government securities increased from 30 to 32 per cent. The major consequence of this policy was that deposits got impounded to the extent of about Rs 500 crores. The individual banks' liquidity position got out of gear and added to the dislocation in banking.

The credit policy announced for the slack season, May-October 1974, stipulated the NLR as 38 per cent (33+5 per cent) instead of 39 per cent (32+7 per cent) in the busy season. How can a bank maintain liquidity of 38 per cent and yet expect to meet the real needs of industry for credit in adequate measure? The coming years indicate an expansion in production requiring a larger volume of credit. It is suggested that the liquidity requirements of banks be gradually brought down to 30 per cent (25+5 per cent) over the next two to three years to release banking resources for business needs.

The present cash reserve ratio of 4 per cent appears to be reasonable, but the present requirement of 33 per cent for Government securities appears to be on the high side and will act as a constraint on banking resources for productive use. As the economy picks up, liquidity requirements need gradual relaxation. The banking sector will be able to meet adequately the Government's need for resources through public borrowing. In an annual addition of Rs 1,500 crores even at the ratio of 25 per cent the Government can depend on banks for nearly Rs 400 crores.

Ultimately, inflation can only be contained by increased production. Inflation in India is the result of economic stagnation. The solution lies in increasing production of quality consumer goods at a cheaper cost. The success of an increasing production policy depends on a larger availability of credit and capital. Credit policy has, therefore, necessarily to be based on expansion of credit. It is reiterated that a policy of credit restraint by itself will not bring down prices. There is an excessive concern in regard to expansion of bank credit and

there is inadequate appreciation of the credit needs for production and exports. Closer consultation between industry, banks, economists and the Government than exists at present is desirable. An official review of the credit policy every quarter, rather than twice a year, and an appropriate credit policy in the light of this quarterly revision is necessary. So long as it can not be established that there has been any speculative inventory buildup in any sector of industry, any large increase in bank credit need not cause the kind of alarm it has caused in the past. It is perhaps not proper to say that by an even more stringent credit policy and high interest rate policy we could have hoped to succeed in reversing the price situation.

It is a welcome sign that the Reserve Bank of India has decided to reduce the present minimum statutory balance from 5 to 4 per cent on demand and time liabilities. The sum thus released, about Rs 120 crores, will be used by the banks for meeting the credit needs of the busy season in 1974–75 in accordance with the priorities.

Table 3.13 brings out the data on sectoral deployment of gross bank credit available in respect of the 54 banks which account for a little over 97 per cent of the total bank credit for the system as a whole. It shows an increase of only 12 per cent in June 1975 as against 28 per cent in the corresponding period of the previous year.

In regulating commercial bank credit expansion the Reserve Bank has, in the last two years, operated a wide variety of monetary weapons. The most important element of policy is to regulate the resources of banks available for lending and to restrict the refinances and rediscount assistance available from the Reserve Bank. As a matter of normal practice, commercial banks can lend only what is available to them after meeting the two minimum statutory requirements: the statutory cash reserve requirement and the statutory liquidity reserve requirement. According to the Reserve Bank of India Act, banks are obliged to keep a minimum of 4 per cent of their demand and time liabilities in cash with the Reserve Bank which is statutorily empowered to increase this minimum requirement to 15 per cent.

During 1973–74, the Reserve Bank fixed this ratio at as high a level as 7 per cent. Since December 1974, this ratio stands at 4 per cent. In addition to the cash reserve ratio, banks are also required to maintain a minimum ratio of 25 per cent of their demand and time liabilities in specified approved assets, mostly Government and semi-Government securities. This ratio can also be varied and at present it has been fixed at 33 per cent.

Thus, for every Rs 100 which banks raise by way of deposit resources, they are obliged to keep Rs 37 with the Reserve Bank, in the form of statutory cash deposit (Rs 4) and in the form of approved investments (Rs 33). Thus, what is available to them for the purpose of expanding credit will be only Rs 63 out of every Rs 100 of deposits; and this amount can also be varied from time to time by the Reserve Bank by varying the cash and liquidity reserve requirements.

This is not to say that bank lending cannot be in excess of Rs 63. They can do so with the assistance of the Reserve Bank, provided the Reserve Bank is willing to give refinance and rediscount accommodation. While providing assistance to

the scheduled commercial banking sector, the Reserve Bank has to keep in mind the primary consideration that its assistance is really made out of created money. In other words, Reserve Bank assistance will have the same effect as deficit financing. Hence in the last few years, the Reserve Bank has been pursuing an extremely cautious policy with reference to its lending. At present, the bank rate is 9 per cent and the refinance facilities made available by the Reserve Bank carry a rate of interest ranging between 9 and 18 per cent. Similarly, the rate of discount on bill rediscount accommodation varies from 9 to 15 per cent.

TABLE 3.13. Sectoral Deployment of Gross Bank Credit 1973-74 and 1974-75

(including bills rediscounted with RBI)

(54 Banks which account for 97.2 per cent of Bank Credit)

(In crores of rupees)

	Busy Season 1973-74			*Busy Season* 1974-75		
	Public Sector	*Private Sector*	*Total*	*Public Sector*	*Private Sector*	*Total*
	1	2	3	4	5	6
1. Public Food Procurement Credit	+187 (48.6)	-	+187 (13.5)	+305 (68.5)	-	+305 (30.3)
2. Priority Sectors (including Export Credit)	+11 (2.8)	+201 (20.1)	+212 (15.8)	+6 (1.4)	+184 (32.7)	+190 (18.9)
Of which a) Small Scale Industries	+4 (1.0)	+152 (15.2)	+156 (11.8)	+2 (0.4)	+75 (13.3)	+77 (7.6)
b) Agriculture	+7 (1.8)	+24 (2.4)	+31 (2.2)	+6 (1.2)	+75 (13.3)	+81 (8.0)
3. All other Sectors* (Including Export Credit)	+187 (48.6)	+798 (79.9)	+985 (71.2)	+134 (30.1)	+378 (67.3)	+512 (50.8)
4. Non-food Credit (2+3)	+198 (51.4)	+999 (100.0)	+1,197 (86.5)	+140 (31.5)	+562 (100.0)	+702 (69.7)
5. Of item 4—Export Credit	+41 (10.6)	+178 (17.8)	+219 (15.8)	+9 (2.0)	−7	+2 (0.2)
6. Total Gross Credit (1+4)	+385 (100.0)	+999 (100.0)	+1,384 (100.0)	+445 (100.0)	+562 (100.0)	+1,007 (100.0)

* Includes large and medium industries and wholesale trade.

Note: Figures in brackets are proportions to Gross Bank Credit.

Source: *Business Standard*, July 19, 1975.

Apart from restricting the lendable resources of banks the Reserve Bank has pursued a positive interest rate policy in order to restrain the demand for bank credit by prescribing a minimum lending rate of 12.5 per cent except for some exempted categories. In addition, the Government has imposed a 7 per cent tax on interest income on advances. Both taken together result in an effective minimum lending rate of 13.5 per cent. Bank deposit rates have also been stepped up, the maximum rate on deposits for a period beyond 5 years being 10 per

cent. Reflecting these considerations, the bulk of bank lending takes place in the range of 15–18 per cent.

X

Observations

Firstly, the ratio of bank credit to deposit reached record levels during the Plan period exceeding greatly the accepted limits of sound banking. During the First Plan period the average ratio of bank credit to total deposits was 61.0 per cent. During the Second Plan period the average ratio was 69.6 per cent. Thus, even though the scheduled banks were over-loaned during the First Plan period, they were much more so during the Second Plan period. During the Third Plan period, the credit-deposit ratio was 77.6 and in 1970–71 it was well above 78.8 per cent.[18] Did the Reserve Bank do nothing to check it? How is this to be explained? It seems that the Reserve Bank of India was caught in a dilemma. It had to choose between a conventional principle of sound banking, which would have limited the expansion of bank credit, and its monetary-credit policy which was to be kept deliberately liberal so as to enable the private sector to fulfil the investment and production targets of the Five Year Plans. A more conventional banking policy might have been more stabilising but would have limited the growth of private industrial sectors.

Secondly, the Reserve Bank's policy was expansionary for a certain class of borrowers and restrictive for others. Considering the ambivalent orientation of the Reserve Bank of India in expanding and restricting credit at the same time the effect on the allocation of credit was, by and large, satisfactory.

Thirdly, the Reserve Bank can at best, directly or indirectly, vary the growth-rate of the distribution of bank credit of scheduled banks, but there exist alternative sources of finance which are not controlled by it and can counteract the efforts of the monetary authorities. Changes in the lending preferences of bankers were partly induced by the credit policy of the Reserve Bank and partly caused by market forces. Whatever the reasons the Reserve Bank achieved fair success in respect to its principal goals of increasing the availability of credit at higher cost thereby enforcing credit rationing by banks, and in changing the allocation of credit in favour of the industrial sector. This is proved by the decline in the proportion of bank credit going into the trading and financial sectors. The increase in the share of the industrial sector and, even more so, in that of the newly developing industries is remarkable. The Reserve Bank of India can take the credit for substantially increasing the volume of credit but, at the same time, it was not entirely successful in preventing its misuse.

The policy of the Reserve Bank has not affected bank credit to industry adversely. In fact, industry has had the lion's share of bank credit. In 1951 industrial credit accounted for about one third of the total bank advances; the position now is that a little under two thirds of the total scheduled banks' credit

[18] On March 28, 1975, the credit-deposit ratio has come down to 72.42.

goes to industry. The incremental ratio of industrial advances to total scheduled bank credit has risen in the Third Plan period to 79 per cent. Indeed bank credit is being used by industry not merely for the traditional purpose of working capital but to some extent as a substitute for long-term funds which it used to obtain through the capital market.

Has the policy of the Reserve Bank of India achieved success in altering the composition of bank credit in accordance with the priority sectors? Recent bank credit data show that the scheduled banks are not unmindful of the priority sector. But the creation of the National Credit Council by the Government of India with the Governor of the Reserve Bank as its vice chairman attests the fact that the Reserve Bank has not been successful firstly in achieving the ultimate objective of channelising scarce capital to priority and other desired sectors of society; secondly, in assessing the demand for bank credit from the various sectors of the economy; and thirdly, in coordinating lending and investment policies between commercial and cooperative banks and specialised agencies to ensure the optimum and effiicent use of the overall resources.

There have been complaints that several important sectors in the economy such as agriculture, small-scale industry and exports have not received their due share, even after nationalisation of the major banks. The problem has assumed added significance with the prospective increase in demand for credit both in range and depth, at a time when the deposit resources accruing to the banks have not been able to keep pace. To align the functioning of the banking and credit system of the country to the objectives and requirements of national economic development more closely, it is necessary to have a periodical assessment of the demand for bank credit and determination of priorities for lending and investment among various sectors of the economy.

The most basic and sensitive problem of credit is to arrive at an accurate estimate of the credit needs of the various sectors of the economy and of the various units within each sector, not on the basis of any ideological considerations or prejudices, but strictly on economic reasoning, needs and priorities. It has become too commonplace to talk in terms of priorities for agriculture and small-scale industries and of a denial of credit to big industries or those which are associated with the directors of banks. But the assumption is perhaps wrong that big industries, directors' concerns, trading activities or other credit needs not covered by the fashionable priorities can be ignored. These impromptu decisions carry with them the risk of a serious strangulation of genuine and legitimate economic activity on account of a shortage of credit. In view of this situation, the credit cell of the Reserve Bank of India can succeed only if it isolates the economic considerations from ideological preferences and bases its recommendations on the actual credit needs of the economy. The Reserve Bank has not been successful so far in routing credit to the priority sectors of the national economy. Also, the members of the erstwhile National Credit Council representing separate sectors have not risen above their respective interests to take an overall view of the credit needs of the economy.

One of the perpetual problems of credit policy is the prejudice of the authorities against the so called clean loans. The Reserve Bank has so far failed to dis-

tinguish between the security and safety aspect of unsecured loans and the credit control or regulation aspect of these loans. Confusion between the clean and unsecured loans is at the root of many complicated problems of credit policy. The present attitude of banks in financing projects of new entrants in the industrial field is one of great caution. So a new entrepreneur who is without solid security but has integrity and plenty of grit has almost no chance of getting credit from banks. The considerations of security ought not to affect what are inherently genuine and legitimate loans. Another similar, but even more difficult, problem is to determine how far bank credit is responsible for inflationary or speculative spirals, and how far the credit restrictions of the past few years were directly or indirectly responsible for the recessionary tendencies in certain segments during 1966 and 1967 and 'stagflation' in 1974 and 1975. Reflationary credit policy will ultimately depend upon a basic decision on this fundamental issue. Again, while an equitable and purposeful distribution of credit is the immediate problem before the Reserve Bank, the need for mobilising more resources for the organised banking system is no less important. The general view regarding credit allocation is that filling in credit gaps in some sectors should not lead to credit gaps elsewhere. The scope of readjustment is limited because the safety of a loan is a major consideration for a banker. It is difficult to modify this emphasis and still be consistent with prudent banking.

Extravagant claims cannot be sustained in favour of a restraining effect on the level of prices through the policy of regulating the cost and availability of bank credit. The correlation between price trends and control of bank credit, as observed in developing countries, is not strong enough to warrant an implicit faith in the ability of overall credit control to correct a rising price situation. The factors affecting the price situation in these economies are indeed complex. They are structural in character and uncertain in the timing and incidence of their impact. A policy of credit restraint is aimed at reducing the pressures arising from the demand side rather than from that of supply. It can narrow the gap between aggregate demand and supplies to some extent but, clearly, it cannot be expected to restore price equilibrium when the underlying factors have their roots in the supply side or in fiscal deficits operating on demand.

In the ultimate analysis, it is not money but real resources that determine the rate of growth. The rate of monetary expansion that could be allowed has, therefore, to be determined with reference to the availability of real goods and services. Indeed, Professor Chandler, a celebrated authority on central banking, while speaking on the limitations of monetary-credit policies, observes that "if the growth of real output could be purchased by money alone, the central bank could easily solve the problem and solve it in a hurry".[19]

Central banking policies can play no more than a modest role in promoting economic development. Real output or real income can be produced only with real resources, and real output can be increased only as real resources are increased, mobilised and utilised with greater efficiency.[20]

[19] *Reserve Bank of India Bulletin*, December, 1966.

[20] Also Chandler, loc. cit., pp. 2–3.

In the present inflationary conditions, the monetary-credit policy must attempt to obtain the maximum amount of development finance through the mobilisation of the savings of the community. It must also be the concern of the monetary authorities to ensure that the expansion of monetary resources that takes places is utilised to the best possible advantage of the community. The priorities accepted in the Plans and also in the philosophy of social control and bank nationalisation have to be reflected in the functioning of the credit machanism. In other words, the objective is not to deny the credit requirements of the productive sectors of the economy but to ensure that the resources are found from genuine savings as far as possible and that credit is used in the most efficient manner. To achieve this the monetary-credit policy has to be used in such a way that it brings about conditions in which funds required for the growth of the economy are available to the various sectors in the right magnitude and composition at the right time. The corollary of this is that the volume of inessential investment should be restrained. It is in this way that the productivity of investment in general will be increased. The rate of interest plays an important part in securing this objective. If productive enterprises are cost conscious they are bound to take notice of the interest-cost and organise their production in such a manner as to maximise the return from borrowed capital. An appropriate interest rate structure brings the cost of capital into closer alignment with its scarcity value in the economy and in this manner induces a more efficient allocation of productive resources. This is certainly an objective well-worth pursuing.

The main component of the monetary policy administered by the Reserve Bank is credit which, broadly, is the indebtedness of the Government, commercial institutions and individuals to the banking system including for this purpose the Reserve Bank, the commercial banks, and the financial institutions. There is close interrelationship of credit with the total gamut of economic policy.

The view that now seems to be gaining ground is that economic growth in India calls for greater emphasis on agricultural production and mass consumption goods or wage goods. Attention will continue to be paid to power and transport equipment, iron and steel, cement, fertilisers, etc., for the purpose of achieving an increase in agricultural production or wage goods output. The strategy of according high priority to agriculture also subserves India's social philosophy of distributive justice, as income is distributed over a larger section of the population. The current rise in the price level, by leaps and bounds, stems basically from a shortage of wage goods production and distribution. The need for laying proper emphasis on the development of the infrastructure and inputs of wage goods and agriculture is thus urgent and axiomatic. This, then, is the basic framework of economic policy conditioning credit deployment. Increased supply of credit for the development of the infrastructure and inputs needed in wage goods industry, agriculture and for exports also are the broad parameters of credit policy. The operational constraints that have stood in the way of a free flow of credit to such sectors as agriculture, have to be met by bankers with a new sense of purpose in making their contribution to economic development. The traditional assumptions governing the attitudes

of credit users relating to the inevitability of large carry-over of inventories by industry, need to be reviewed. Similarly, the bankers' view that only incremental credit can go to the priority sectors and that redeployment of some of the existing credit is not possible, needs examination. Whatever the difficulties, the banks should move towards the new information system envisaged in the guidelines for following up bank credit as it was geared to dovetail the credit deployment with production requirements and ensuring end-use of funds. The new information system sought to be established was intended to assist in improving the quality of supervision and to know whether the borrower was responsive to the required discipline. Intrinsically, forms introduced in the guidelines for the follow up of bank credit represent an information system and should be looked at primarily from that angle.[21] The objective was to ascertain how much credit was required *vis-a-vis* production requirements and to ensure the end-use of funds.

To conclude, bank credit is within the direct sphere of influence of the central banker who may, however, encounter difficulties and resistance.[22] For effective control of bank-credit he must be endowed with adequate statutory powers and resources. All the commercial banks should be brought within the purview of the central banker and have direct customer relations with him. They must regularly supply the central banker with the requisite statistical and descriptive data concerning their operations and must cooperate whole-heartedly and intelligently with him in carrying out the credit policy. It is also necessary that whenever credit control devices by the monetary authorities prove inadequate to attain the desired objective, they should be advantageously supplemented by appropriate fiscal policy or other action of the Government.

The precise manner in which credit policy is put into effect depends on the particular needs of the situation such as the degree of imbalance present in the overall supply-demand situation as reflected in the current price trends, the outlook for agricultural and industrial production, the balance of payments position, the special problems of particular sectors and so on. For the purpose of formulating the correct credit control policy, the central banker should be able to ascertain definitely the extent to which bank credit alone is responsible for a given situation as compared with the operation of nonmonetary factors and should also aim at being able to determine the particular stage of the business cycle "with a view to deciding not only when to act but what to do and how far to go".[23]

[21] Seminar of Study Group to Frame Guidelines for follow up of Bank credit vide *Reserve Bank of India Bulletin*, October 1974 and May 1975, pp. 359–361.

[22] For an excellent discussion see De Kock, M. H., *Central Banking*, Staples Press, London, pp. 134–160.

[23] Ibid., p. 159.

4

The Policy of the Reserve Bank of India and the Investment Portfolio of Scheduled Banks

Theory and Practice of Investment Portfolio Management

The manager of a bank is expected to know the level of demand and time deposits, the capital and reserves and also the rates of profitability of its assets. He has to choose among four assets; investment in government securities, other securities, bills discounted, and loans and advances. The bank is required to adhere to two restrictions. The first requires that part of the bank's deposits must be held in the form of balances with the Reserve Bank as per Section 42(1)of the Reserve Bank of India Act, 1934, and part must be held in unencumbered approved securities as defined under Section 24 of the Banking Regulation Act, 1949. The second set of restrictions requires the portfolio manager to decide what liquidity should be maintained, taking into account the owned funds, the liquidity of its liabilities and the extent of liquidity of the various types of assets. When liquidity restrictions are specified, a relationship is established between the owned funds of the bank and the liquidity the manager of the bank requires of the bank's liabilities as well as the extent of the liquidity of the assets.[1]

The portfolio manager is confronted by a constant paradox. The dilemma arises from the conflict of how to manage effectively liquidity and yield simultaneously in an environment of constantly shifting interest rates, rapid changes in market forces, and a situation of uncertainty. Liquidity, or the lack of it, has always played a crucial role in effective bank management in the post-War period. It is, therefore, useful to look briefly at the evaluation of liquidity theory as a check on past and present portfolio management practices.

The traditional theory of commercial bank liquidity or the 'Real Bills doctrine' that acquired widespread acceptance prior to World War I, is that commercial

[1] Rangarajan and Satia, "Bank Portfolio Management—A Linear Programming Approach", in *Financial Development and Economic Growth*, Sametz, A. W. Ed., New York University Press, 1972, pp. 186–190.

banks should make only short-term, self-liquidating productive loans. Though this doctrine sounds ideal and effective, it conceals several fallacies and has fallen into disuse as a practical guide to bank management since World War I when large amounts of Government securities were acquired. The practice was further eroded in the 1920s with the emergence of consumer and mortgage lending along with substantial investment banking activities involving bonds and equities. With the shifts in loan and investment practices in the 1920s and the growing importance of the Federal Reserve in its role as a liquidity manager, the second important theory of bank liquidity—the 'shiftability theory'—evolved. Liquidity is tantamount to shiftability. Emphasis was placed on the 'shiftability'—the marketability or transferability of bank assets. Maintenance of a substantial quantity of assets which can be shifted on to other banks before maturity in case of necessity is essential. The theory also acknowledged that the central bank plays a crucial role as the ultimate liquidity provider in the system. The shiftability theory ran into difficulties in the 1930s when the banking system found itself in trouble; shiftability evaporated and assets could not be transferred under any circumstances. Confidence was shattered and liquidity, too, was drained from virtually all financial assets.

Following World War II, a new theory of bank liquidity known as the 'anticipated income theory' was evolved by Herbert Prochnow.[2] This theory emphasises the anticipated income of the borrower. The ultimate ability to liquefy obligations is embodied in the earning power and reputation of the borrower or credit taker rather than the ability to shift assets in the market place. All the three theories have been supplemented in recent years by shifting emphasis to liability management. This new theory places less reliance on the generation of liquidity through asset composition and management but recognises the growing importance of the diverse ways in which banks raise funds through the accumulation of a widening array of liabilities. The three critical principles that the portfolio manager must consider are risk, liquidity, and reward. Risk protection is the first and foremost guiding principle of portfolio management.

> Today, the problem is approached in a broader, more flexible manner, taking into consideration the cash flow to be derived from all asset employments as well as careful liability management...the banking system has learned to live with sharply reduced liquidity as compared with the earlier postwar period....[3]

II

The Need for Secondary Reserve

Since both the monetary-credit policy of the central bank and the lending policy of the commercial banks (pertaining to loans and bills discounted) are

[2] Prochnow, H. V., "Bank Liquidity and the New Doctrine of Anticipated Income", in *Money and Economic Activity*, Ritter, L. S., Ed., Houghton Mifflin, Boston, 1961, pp. 57–59.

[3] *The Changing World of Banking*, Prochnow & Prochnow, Eds., Harper & Row, pp. 173–174.

related to the investment portfolio and the liquidity of the entire assets mix, it has been considered necessary to focus attention on the policy of the Reserve Bank of India in relation to the investment portfolio of scheduled banks.

The investment operations of commercial banks in India are principally confined to the purchase and sale of Government and other trustee securities. For example, in the investment portfolio of scheduled banks, Government and other trustee securities consisted of 93.7, 95.7, 96.5 and further upto 97.6 per cent of total investments as on March 31, in 1966, 1970, 1972 and 1974 respectively.[4] In fact, they hold a large portion of the marketable debt and respond sensitively to the changes in the monetary policy. They mobilise the savings of the community and funnel them into the capital market. Thus, the banking system transmits the impulses of the monetary policy to the rest of the economy through the capital market.

Banks always prefer to invest in certain types of earning assets which are not only liquid but are also immune from the risk of default. The secondary reserve of a commercial bank consists of its liquid earning assets which may be converted into cash without delay or appreciable loss. The term 'secondary' implies that its function is secondary in nature. This is true since the major function of the secondary reserve is to supplement the primary reserve which consists of cash and its equivalent (i.e., deposits with the central bank, cheques etc. held in the process of collection, and deposits with other banks). The secondary reserve is, therefore, a second line of defence of a commercial bank. The instruments that serve the secondary reserve needs of commercial banks possess a high degree of liquidity and at the same time provide a moderate yield.[5] The operations of the primary and secondary reserves may be likened to two linked reservoirs. The character of the secondary reserve is maintained to replenish the primary reserve in the event it drops below a required level. "It is a haven for funds not immediately needed in the primary reserve which will produce income for the bank and yet can be converted into cash quickly".[6] The secondary reserve is thus designed to strengthen primarily bank liquidity. The heart of bank liquidity remains in secondary reserves that are generally low risk, highly marketable, short-term securities. Now, the factors that determine the size of the secondary reserve are complex and uncertain. The need for secondary reserve arises from the change in the character of deposits and demand for loans and advances. The maturity period of investment also plays an important part in determining the size of the secondary reserve. To determine the requirements of different classes of assets of a bank, i.e. bank liquidity, is difficult since different assets have different degrees of quality, marketability, and maturity. And this poses a problem. Cyclical movement dictates that this portion of the portfolio be built up during periods of slack,

[4] *Reserve Bank of India Bulletin,* December 1966, p. 1515; May 1969; November 1972, pp. 1965–1971; Sept. 1973, pp. 1468–1478; and May 1975, pp. 291–306.

[5] Woodworth, G. Walter *The Money Market and Monetary Management,* Harper & Row, New York, 1964, p. 3.

[6] Reed, E. W., *Commercial Bank Management,* Harper & Row, New York, Evanston and London, p. 138.

as in recessions, to provide a cushion for loan and deposit movements during periods of expansion when monetary policies may be restrictive.[7]

III

The Seasonal Swings in the Investment Operation Ratios

The seasonal variations in the operating ratios of scheduled banks reflect, interestingly, an inverse relationship between investment ratio and credit-deposit ratio.[8] A rising credit ratio generally goes with a declining investment ratio. During the busy season the investment ratio goes down as the credit ratio goes up, as can be seen from the respective figures of any year (Table 4.1). The extent of variation will, no doubt, be determined by the changes in the demand for bank credit.

Another interesting feature is that in India the cash ratio and the investment ratio move in the same direction. They generally go up in the slack months (Table 4.2) and go down in the busy period. This behaviour implies that banks can, to some extent, substitute one for another.

There might be a departure from this feature in the case of a few banks, especially the State Bank of India due to their own investment policy or other extraneous reasons. Foreign banks are generally not interested in tying up their funds in Government securities, they maintain the lowest cash ratio and a comparatively smaller investment ratio than the Indian banks in general (Table 4.3). This is the reason which enables them to maintain an average credit ratio at a level well above the average maintained by Indian banks. A bank's ability to switch from investment portfolio to advances depends absolutely on the attitude, policy and encouragement of the central monetary authority, in this case, the Reserve Bank of India.

Table 4.1 demonstrates absolute changes in investments and bank credit as well as their ratios to deposits during the busy-slack periods of 1950–51 to 1966-67 and it is evident that in the seasonal variations the investment and bank credit move in opposite directions.

Table 3.2 in the previous chapter also throws a flood of light on the seasonal variations during the Fourth Plan period (Slack 1969–busy 1973-74) and depicts the same trends.

Excepting the busy months of 1957–58 and the slack period of 1960[9] investments in Government securities have contracted in busy months and expanded in every slack season. The slack months of 1956 shows a relatively small increase in investments because of the relatively high demand for bank credit. This proves that, faced with a choice between the two, banks will prefer loan to investments. On the other hand, the usual busy season of 1957-58 did not show the usual phenomenon, and demand for bank credit was less. This resulted in

[7] Prussia, L. S., (Jr.), "Bank Investment Portfolio Management", in *The Changing World of Banking*, op. cit., pp. 146–187.

[8] These will be referred to as credit ratio.

[9] Variations underlined in Table 4.1.

TABLE 4.1. Seasonal Variations in Investment in Government Securities and Bank Credit, 1950-51–1966-67

(Amounts in crores of rupees)

Season	*Investment in Govt. securities*	*Investment ratio*	*Bank Credit*	*Credit Deposit ratio*
(1)	(2)	(3)	(4)	(5)
Slack 1950	+ 37.8	43.1	− 74.43*	47.7*
Busy 1950-51	− 65.9	34.8	+163.43*	65.4*
Slack 1955	+ 47.7	38.4	− 31.55	58.0
Busy 1955-56	− 36.9	33.4	+164.4	71.2
The Second Plan Period				
Slack 1956	+ 16.0	34.2	+ 36.7	70.0
Busy 1956-57	− 26.9	28.2	+148.4	74.5
Slack 1957	+ 49.6	28.9	− 41.8	63.6
Busy 1957-58	+ 50.4	29.4	+ 89.4	63.3
Slack 1958	+174.7	39.3	−117.9	53.2
Busy 1958-59	− 31.8	36.4	+181.7	60.3
Slack 1959	+178.0	44.2	− 78.9	52.3
Busy 1959-60	− 52.4	38.4	+188.9	58.6
Slack 1960	− 52.3	36.2	− 20.3	58.2
Busy 1960-61	−126.3	29.4	+198.5	68.3
The Third Plan Period				
Slack 1961	+ 62.5	34.5	− 76.5	67.6
Busy 1961-62	− 25.0	30.5	+203.8	72.6
Slack 1962	+111.9	34.7	− 42.1	67.5
Busy 1962-63	− 97.6	29.4	+203.2	76.1
Slack 1963	+145.6	34.0	−120.9	65.7
Busy 1963-64	−145.4	26.5	+376.2	79.5
Slack 1964	+258.5	34.5	−138.7	67.4
Busy 1964-65	−154.2	27.2	+413.4	80.2
Slack 1965	+138.6	30.5	− 93.3	71.7
Busy 1965-66	− 27.3	27.4	+309.5	76.9
Period After The Third Plan				
Slack 1966	+298.1	34.3	− 85.6	68.1
Busy 1966-67	−198.0	26.9	+425.6	77.1

The Slack Season is from May to October and the Busy Season from November to April.

* Excluding foreign bills purchased and discounted in India and including Money at call and short notice.

Col. 2 – At book value; includes treasury bills and treasury deposit receipts.

Col. 3 – Percentage of investment in Government securities to aggregate deposits.

Col. 4 – Includes foreign bills purchased and discounted in India from May 14, 1954.

Sources: Compiled from—

(1) *Report on Currency and Finance*, Reserve Bank of India, 1964-65, p. S29.

(2) For data relating to the period, 1965-67, Reserve Bank of India, *Report on Currency and Finance*, 1966-67, p. S62.

TABLE 4.2. Seasonal Fluctuations in the Operating Ratios of Scheduled Banks, 1950-51–1966-67

Season	*Cash ratio[a] at the end of the period*	*Investment ratio[b] at the end of the period*	*Credit-deposit ratio[c] at the end of the period*
Slack 1950	13.0	43.1*	47.7*
Busy 1950-51	9.9	34.8*	65.4*
Slack 1955	9.1	38.4	58.0
Busy 1955-56	8.1	33.4	71.2
The Second Plan Period			
Slack 1960	7.6	36.2	58.2
Busy 1960-61	6.3	29.4	68.3
The Third Plan Period			
Slack 1961	7.3	34.5	67.6
Busy 1961-62	6.7	30.5	72.6
Slack 1962	6.1	34.7	67.5
Busy 1962-63	6.2	29.4	76.1
Slack 1963	7.7	34.0	65.7
Busy 1963-64	6.1	26.5	79.5
Slack 1964	6.1	34.5	67.4
Busy 1964-65	6.1	27.2	80.2
Slack 1965	6.5	30.5	71.7
Busy 1965-66	6.2	27.4	76.9
Period After The Third Plan			
Slack 1966	6.0	34.3	68.1
Busy 1966-67	6.1	26.9	77.1

* Excluding foreign bills purchased and discounted in India and including Money at Call and Short Notice.

[a] Percentage of cash and balances with the Reserve Bank of India to aggregate deposits.

[b] Percentage of investments in Government Securities to aggregate deposits.

[c] Percentage of Bank Credit to aggregate deposits.

Sources: Compiled from—

(1) *Report on Currency and Finance*, Reserve Bank of India, 1964-65, Statement 19, p. S29.

(2) For data relating to 1965-1967, Reserve Bank of India, *Report on Currency and Finance*, 1966-67, p. S62.

the investment of surplus funds in Government securities. The slack season of 1960 shows contraction in investment because of the change introduced in the banking of PL 480 funds, whereby under the new arrangement the State Bank of India had to unload the Government securities locked up in PL 480 funds and transfer the equivalent amount of time deposits to the Reserve Bank of India.

From the preceding analysis of seasonal variations of the operating ratios of banks, we can conclude that the investment ratio passively adjusts to a change in the credit ratio. The stronger the busy season, the greater will be the fall in the investment ratio and higher will be credit ratio. In a reverse situation the opposite will happen. However, this conclusion cannot be applied in general to all classes of banks as different classes of banks behave differently.

TABLE 4.3. The Ratio of Investments in Government Securities to Deposits—Classified According to Foreign Banks, Indian Banks and State Bank of India 1955–1965

Year	*State Bank of India*	*Other Indian Banks*	*All Banks*	
			Foreign	*Indian*
1955	47.7	35.6	23.6	38.3
The Second Plan Period				
1956	39.3	36.0	20.9	23.7
1957	46.4	26.7	19.0	32.2
1958	56.0	34.2	22.8	40.4
1959	62.1	31.5	18.9	42.1
1960	49.2	21.6	16.6	34.2
*The Third Plan Period**				
1961	44.46	30.88	17.07	35.67
1962	50.18	30.53	17.97	36.86
1963	41.84	29.52	19.50	36.13
1964	43.32	29.75	26.05	33.88
1965	40.08	29.45	28.19	32.57

Note: Data relating to the Fourth Plan period also indicate the similar trends.
* Percentage of total investments (including others) to Deposits.
Sources: (i) Compiled from Statistical Tables Relating to Banks in India, 1955-60.
(ii) Data for the years 1961-65—Statistical Tables Relating to Banks in India, 1965, p. 14, and other relevant years.

The shift of bank credit in favour of the industrial sector has tended to strengthen the busy and weaken the slack seasons as momentum for industrialisation gets accelerated in the developmental planning period (see Chapter 3). Bank funds are flowing more to the industrial sector and to newer industries which are not based on agriculture such as iron, steel and engineering products, minerals, and chemicals. The seasonal pattern itself has been undergoing substantial changes and seasonal swings influencing the investment portfolio are gradually lessening.

IV

Investment Pattern in the Pre-Plan Period

Before we actually analyse the trends of the investment portfolio of commercial banks in the planned period, an analysis of the investment pattern in the pre-Plan period will be of immense interest for the purpose of our investigation. The investment behaviour of banks during the War period is exhibited in Table 4.4

It is thus significant to observe that the amount of investments registered a progressive rise during the War period. The investment of all commercial banks stood at about Rs 129 crores in 1941; it increased more than three-fold during the War years, touching a total of Rs 460 crores in 1945. Due to war time

TABLE 4.4. Investment of All Commercial Banks 1941–1950

(In crores of rupees)

Year	*Investment*
1941	129
1942	229
1943	327
1944	397
1945	460
Period Prior to The Plan	
1949	403*
1950	416*

* Relates to scheduled banks only.
Source: *Reserve Bank of India Bulletin*, relevant issues.

controls and restrictions on private trade, the scope for other profitable avenues of investment was limited. There are also other causes for this phenomenon. The volume of deposits grew as a result of the war time expansion of currency. Investment was mounting as this money did not find any outlet for ready application in risk ventures. Uncertainties in the economic field were also responsible for this upward trend in the investment portfolio.

The investment ratio, however, reflected a progressive decline, especially in in the postwar economy as will be evident from Table 4.5.

TABLE 4.5. Ratio of Investments to Total Deposits of Commercial Banks, 1942–1950

Year	*Investment-Deposit Ratio (approximately)*
1942	59
1943	54
1944	54
1945	52
Period Prior to the Plan	
1946	47
1947	47
1949	46*
1950	48*

* Relates to Indian scheduled banks only.
Source: *Reserve Bank of India Bulletin*. relevant issues.

A sharp fall in the investment-deposit ratio was thus recorded just after the War. During the postwar period, bank credit was moving upward due to the opening up of new investment opportunities with the gradual relaxation of restrictions imposed during the War. There was, therefore, a high effective demand for bank credit. The result was the liquidation of investments to meet the growing requirements for bank funds resulting in a corresponding fall in

the investment-deposit ratio. The pattern of the investment portfolio in the post-war period thus reflected its responsiveness to the change in economic activities demanding more funds for industrial and commercial sectors. Incidentally, it may be mentioned that a similar trend was noticed in the USA, UK, and Canada also. The end of the War saw business picking up. Under booming business conditions, Government securities became unattractive as earning assets since they have low yields relative to those possible from private borrowings.

V

Investment Behaviour in the Plan Period

In Tables 4.6 and 4.7 we see that although the volume of investments exhibited a progressive rise, the investment ratio has, however, been gradually declining during the plan period. The cash ratio, too, has been falling while the credit ratio has registered a gradual rise. This is a natural development of the growth of the industrial sector calling for increasing bank credit. In the absence of an adequate inflow of deposit resources into the banking sector, banks have been compelled to meet their requirements by economising on cash balances and, partly, by liquitation of investments. From Table 4.7, we observe that total

TABLE 4.6. Ratios of Cash, Investment and Bank Credit to Total Deposits of the Scheduled Banks, 1950-51–1966-67

(Percentages)

As at the close of last Friday	*Cash/Deposit Ratio*	*Investment/Deposit* Ratio*	*Bank Credit/Deposit Ratio*
(1)	(2)	(3)	(4)
1950-51	10.6	N.A.	22.1
1955-56	8.1	34.5	73.0
1960-61	6.7	32.0	75.6
The Third Plan Period			
1961-62	6.4	31.3	73.2
1962-63	6.2	29.0	77.8
1963-64	6.5	28.0	79.5
1964-65	6.3	27.8	78.8
1965-66	5.8	27.5	77.6
Period After The Third Plan			
1966-67	6.3	26.1	78.6

N.A. Not Available.

* Including Treasury Bills and Treasury Deposit Receipts.

Sources: Compiled from

(i) *Report on Currency and Finance*, Reserve Bank of India, 1964-65, Statement 20, p. S32.

(ii) *Report on Currency and Finance*, Reserve Bank of India, 1966-67, Statement 28, p. S48.

TABLE 4.7. Trends in Investments and the Other Operating Assets of the Scheduled Banks, 1955-1966

(Amounts in crores of rupees)

Last Friday of December	*No. of Reporting Banks*	*Demand Deposits (excluding inter bank deposits)*	*Time Deposits (excluding inter bank deposits)*	*Aggregate deposits*	*Cash in hand and balances with Reserve Bank*	*Total Bank Credit**	*Investment Govt. securities†*	*Others*	*Total Investments*
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
The Second Plan Period									
1956	89	603.4	449.1	1,052.5	90.5	744.9	364.2	30.6	394.8
1957	91	658.9	638.7	1,297.5	107.6	819.5	432.9	50.8	483.7
1958	93	649.8	866.4	1,516.2	119.4	830.6	637.0	54.9	691.9
1959	94	668.9	1,097.9	1,766.8	113.9	921.9	787.4	67.6	855.0
1960	93	721.0	1,086.4	1,807.3	162.0	1,130.0	630.3	63.4	693.7
The Third Plan Period									
1961	82	732.6	1,102.1	1,834.7	155.8	1,277.0	577.0	74.8	651.8
1962	80	816.9	1,222.0	2,038.9	132.7	1,421.8	646.2	91.3	737.5
1963	79	997.2	1,255.6	2,252.8	141.4	1,580.9	707.2	122.4	829.6
1964	76	1,178.3	1,345.7	2,524.0	160.3	1,811.0	764.4	140.3	904.7
1965	76	1,367.2	1,520.1	2,887.3	208.7	2,104.8	826.2	167.8	994.0
1966	76	1,582.6	1,795.8	3,378.4	249.0	2,434.2	952.0	202.0	1,154.0

Note: 1. Figures are based on Form XII of the Banking Regulation Act,1949 except those in Column 5 which are based on weekly returns submitted by scheduled banks in terms of Section 42(2) of the Reserve Bank of India Act, 1934.

2. Figures from December 1961 are on a revised basis and consequently are not strictly comparable with those for the earlier years.

* Includes inland and import bills purchased and discounted upto December 1960, and all bills purchased and discounted thereafter.

† Includes Treasury bills and Treasury receipts.

Source: *Trend and Progress of Banking in India*, Reserve Bank of India, 1965, p. 14 and 1966, p. 16.

TABLE 4.8. Percentage Distribution of Investments of Scheduled Banks, 1962-1966
The Third Plan Period

(Amounts in crores of rupees)

	Mar. 31, 1962		*Mar. 31, 1963*		*Mar. 31, 1964*		*Mar. 31, 1965*		*Mar. 31, 1966*		*Variations during the year* 1966
Number of Reporting Banks	81		79		79		79		76		
	Amount	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*	
1. Investments of Indian Offices in											
(a) Indian Govt. Securities	624.62	85.6	626.97	83.4	669.14	80.9	755.12	80.7	820.27	81.5	+65.15
(b) Other Domestic Investments	77.81	10.7	101.37	13.5	133.83	16.2	159.97	17.1	167.27	16.6	+ 7.30
(c) Foreign Securities	4.19	0.5	2.99	0.4	2.80	0.3	2.97	0.3	2.89	0.3	− 0.08
Total of a, b and c	706.62	96.8	731.33	97.2	805.77	97.4	918.06	98.2	990.43	98.4	+72.37
2. Investments of Foreign Offices	23.06	3.2	20.83	2.8	21.27	2.6	17.10	1.8	15.92	1.6	− 1.8
Total of 1 and 2	729.68	100.0	752.16	100.0	827.04	100.0	935.16	100.0	1,006.35	100.0	+71.19

Source: *Trend and Progress of Banking in India*, Reserve Bank of India, 1965, p. 13, and 1966, p. 14.

investments of all the banks increased about three times during the decade 1956–66 but the growth in deposits could not keep pace with the rising demand for credit. Consequently, there was a fall in the investment ratio and a corresponding rise in the credit ratio.

Tables 4.8, 4.8A and 4.8B portray the investment pattern of scheduled banks in the Third and the Fourth Plan period. The progressive fall in the share of Government securities in the investment portfolio and the corresponding rise in the share of other domestic investments noticed in the Third Plan years, continued till the end of the Fourth Plan, upto March 1974. The percentage of investments in Government securities, it may be noted, gradually dropped from 85.6 in 1962, 80.7 in 1965, 79.1 in 1969, 73.9 in 1971 and further to 69.3 in 1974. But the proportion of other domestic investments to the total increased to a greater extent—from 10.7 to 29.9 per cent during the same period. During this period domestic investments increased from Rs 78 crores to Rs1,019 crores. The rise in investment in this category may be attributed to the higher yield on them as compared with Government securities. The only exception was in 1966, with a rise in the share of Government securities in the investment portfolio of scheduled banks, and a corresponding fall in other domestic investments. The relatively lower expansion of bank credit in the 1965–66 busy season may have been partly responsible for arresting the progressive decline in the share of Government securities.

TABLE 4.8A Investment of Scheduled Commercial Banks
March 1969–March 1971
(First two years of the Fourth Plan)

(Amount in lakhs of rupees)

	Mar. 31, 1969		*Mar. 31, 1970*		*Variation during the year*	*Mar. 31, 1971*		*Variation during the year*
	Amount	*Percentage*	*Amount*	*Percentage*		*Amount*	*Percentage*	
	1	2	3	4	5	6	7	8
1. Investment by Offices in India								
(a) Indian Govt. Securities	111,496	79.1	120,128	75.7	+ 8,632	138,165	73.9	+18,037
(b) Other Domestic Investments	27,219	19.3	36,441	23.0	+ 9,222	45,970	24.6	+ 9,529
(c) Investments in Foreign Securities	171	0.1	280	0.2	+ 109	285	0.1	+ 5
Total of a, b and c	138,886	98.5	156,849	98.9	+17,963	184,420	98.6	+27,571
2. Investments by Foreign Offices of Indian Banks	2,153	1.5	1,809	1.1	– 344	2,631	1.4	+ 822
Total of 1 and 2	141.039	100.0	158,658	100.0	+17,619	187,051	100.0	+28,393

Source: *Reserve Bank of India Bulletin*, November 1972, p. 1972.

TABLE 4.8B. Investment of Scheduled Commercial Banks, March 1972-March 1974 (Last Three Years of the Fourth Plan)

(Amounts in lakhs of rupees)

Item	Mar. 31, 1972		Mar. 31, 1973		Variation during the year		Mar. 31, 1974		Variation during the year	
	Amount	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*
1. Investment by Offices in India:										
(a) Indian Govt. securities	165,921	72.5	217.646	72.0	+51,725	+31.2	235,862	69.3	+18,216	+ 8.4
(b) Other Domestic Securities, Bonds/ Shares etc.	60,363	26.4	82,240	27.2	+21,877	+36.2	101,981	29.9	+19,741	+24.0
(c) Foreign Securities	248	0.1	260	0.1	+ 12	+ 4.8	324	0.1	+ 64	+24.6
Total of a, b and c	226,532	99.0	300,146	99.3	+73,614	+32.5	338,167	99.3	+38,621	+12.7
2. Investments by Foreign Offices of Indian Banks	2,345	1.0	2,276	0.7	− 69	−2.9	2,496	0.7	+ 220	+ 9.7
Total of 1 and 2	228,877	100.6	302,422	100.0	+73,545	+32.1	340,663	100.0	+38,241	+12.6

Note : Investments in Government Securities and other Trustee Securities and Fixed Deposits with banks are shown at face value and those in shares and debentures at market value or where it is not available at book value.

Source: *Reserve Bank of India Bulletin*, May 1975, p. 301.

With the acceleration of general economic activity in the planned economy, there was greater diversion of funds towards advances. The result was a drop in the investment ratio. The progressive decline in the investment ratio is an important feature as it indicates that deposit resources of the banking system were obviously being applied more and more to making loans and advances for industrial purposes. This behaviour of the banking system is indicative of an accelerated step towards industrialisation in the planned economy.

VI

Maturity Distribution of Government Securities in the Pre-Plan and Plan periods

The post-War years, which roughly correspond to the pre-Plan period, exhibit certain interesting trends in regard to maturity distribution to Government securities. With the cessation of hostilities the stock exchange boom ended. The price of Government securities fell, long-dated securities, especially, declined steeply. As a result commercial banks changed the composition of their investment portfolios. The ratio of investments in Government securities dropped while the percentage of other investments moved up. Long-dated securities were reduced while short and medium securities were added to reflect a more balanced maturity pattern.

The Reserve Bank of India's advice also had some influence towards progressive improvement in the maturity distribution of Government securities in the investment portfolio of commercial banks. The Reserve Bank has both encouraged and assisted commercial banks to secure a more balanced distribution of the maturities of their securities. In March 1948, the banks were advised that there was too marked a preference for long-dated securities and that they should build up a stronger second line of defence in the form of short-term securities.[10] The need for corrective action was further emphasised in the following words:[11]

> Banks which already have followed a wrong policy during the past should gradually reduce their long-term securities so that they do not disturb the Government securities market and are able to spread their losses, if any, over a period of time. They will also have to restrict fresh advance until they have a better balance of their security portfolio.

The Reserve Bank, however, appreciated in its Annual Report of 1949[12] that if these banks attempted

> to dispose of their long-term securities in large blocks, not only may the banks suffer losses themselves, but they might also disturb the Government securities market. In that event, either the Reserve Bank of India or the Government of India may have to step in to support the Government securities market.

The progressive imporvement in the maturity distribution of scheduled bank holdings of Government securities in terms of central bank advice is reflected

[10] Reserve Bank of India Circular No. DRS/905/SY/-130-48.
[11] Reserve Bank of India Circular No. DBO/3797/C-207-48 dated August 10, 1948.
[12] *Trend and Progress of Banking in India*, Reserve Bank of India, 1949, p. 222.

in Table 4.9. At the same time, the Reserve Bank was also interested in keeping the long-term market healthy and was willing to support that market, if necessary, by buying long-dated securities at par.[13]

TABLE 4.9. Maturity Distribution of Scheduled Banks' Investments in Government Securities, 1945–1950
(The Period Prior to the Plan) *(Percentage)*

Year ending December	*Treasury Bills*	*Securities maturing*			
		Within 5 years	*Between 5–10 years*	*Between 10–15 years*	*After 15 years*
1945	4.69	25.09	25.22	19.06	25.94
1946	3.23	18.33	24.08	26.73	27.58
1947	6.33	24.16	22.94	20.05	26.53
1948	0.98	28.76	20.76	31.92	17.69
1949	1.72	28.37	26.85	25.83	17.23
1950	1.12	31.52	22.72	29.71	14.93

Source: Compiled from
Trend and Progress of Banking in India, Reserve Bank of India, 1949, p. 162 and 1950, p. 55.

The tendency to add short-term securities gained further momentum in the Second Plan period.[14] The maturitywise distribution of Government securities in the portfolio of scheduled banks (Table 4.10A) shows that the percentage

TABLE 4.10A. Maturitywise Distribution of Government Securities All Scheduled Banks, 1955-1960
(Second Plan Period)
(Amounts in crores of rupees)

	1 Year	*1–5 Years*	*5–10 Years*	*10–15 Years*	*Over 15 Years*	*Total**
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dec. 1955	10.8(2.9)	83.7(21.00)	239.5(60.5)	46.5(11.7)	15.3(3.9)	396.0(100)
The Second Plan Period						
1956	5.0(1.3)	135.6(35.9)	153.1(40.5)	64.4(17.6)	17.4(4.6)	377.7(100)
1957	12.6(2.8)	223.7(50.0)	140.6(31.4)	51.0(11.4)	19.2(4.3)	447.3(100)
1958	57.8(8.7)	268.7(40.5)	257.2(38.8)	56.0(8.4)	23.6(3.6)	663.5(100)
1959	97.6(12.5)	248.0(31.7)	315.0(40.2)	87.6(11.2)	34.7(4.4)	783.1(100)
March 1960	73.3(9.9)	234.4(31.8)	310.5(42.1)	86.3(11.7)	33.1(4.5)	737.8(100)

Note: 1. Figures within brackets indicate percentages to the total investment in Government securities.
*2. Total figure has been arrived at approximately.
Source: *Trend and Progress of Banking in India,* Reserve Bank of India, 1955-1960.

[13] Sayers, R. S., Ed., *Banking in the British Commonwealth,* p. 241. (Article by Wilson, J. S. G., "The Rise of Central Banking in India".)

[14] As the change in the maturity distribution has been more obvious during the Second Plan period, discussion is taken up from there.

of securities maturing within the 5-10 year group was droppoing. For example, the percentage of Government securities maturing in this group was 60.5 in 1955, gradually coming down to 42.1 in 1960. This proves that banks were distracted from this category more than any other group. In 1956 and 1957 banks unloaded the holdings of medium securities (5-10 years) and acquired short-term securities, mainly those in the 1-5 year group. Long-term securities maturing in 10-15 years and those over 15 years maintained an almost steady level. Incidentally, it may be pointed out that a similar trend was noticed in the USA during 1956-1962 (Table 4.10B).

TABLE 4.10B. Maturity Distribution of Federal Reserve Banks' Holdings of United States' Government Securities, 1956-1962

(*Billions of dollars*)

Dec. 31	*1-5 Years*	*5-10 Years*	*Over 10 Years*
1956	0.4	1.0	1.4
1957	1.4	0.1	1.4
1958	3.9	0.2	1.3
1959	6.5	0.4	1.1
1960	10.7	1.2	0.3
1961	8.7	2.2	0.3
1962	10.8	2.1	0.2

Source: *Federal Reserve Bulletin*, Selected Years.

In India, as in the Second Plan, during the Third Plan period also the maturity pattern of investments of Government securities showed a shift in favour of short-term securities maturing within 5 years as against medium-term securities (Tables 4.11 and 4.12). At the end of March 1965, the ratios of securities maturing between 5-10 year group and 10-15 year group to the total investments in Government securities declined. The share of the short-term securities rose from 42.2 to 56.6[15] per cent while the medium-term securities showed a decline from 45.5 to 33.8 per cent. This was mainly due to the shift in Government securities from the medium to the short-dated group. There was a small decline in the proportion of securities maturing in 10-15 years, though the investments in this group increased by Rs 2.3 crores to Rs 43.31 crores. The proportion of the other two groups of long-dated securities, e.g., those maturing between 15-20 years and over 20 years remained nearly unchanged over the year at 0.2 and 3.0 per cent respectively.

The maturitywise distribution of investments in Government securities showed major changes during 1966 towards increasing preference for the short-term maturities and indicates the banks' concern for the erosion of capital in a period of rising interest rate. The ratio of investments within the 5-10 year

[15] See footnote, Table 4.12.

TABLE 4.11. Maturitywise Investments in Government Securities of India Offices of Scheduled Banks, 1962–1965 (Four Years of the Third Plan Period)

(Amounts in crores of rupees)

	Mar. 31,1962		*Mar. 31,1963*		*Mar. 31, 1964*		*Mar. 31, 1965*	
	Amount	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*
1. Treasury Bills	71.19	11.3	36.69	5.9	19.37	2.9	5.31	0.7
2. Securities maturing*								
(a) within 5 years	229.06	36.6	239.22	38.1	282.72	*42.2***	426.90	*56.6***
(b) between 5 & 10 years	242.39	38.6	279.13	44.5	304.58	45.5	255.50	33.8
(c) between 10 & 15 years	62.25	10.0	51.23	8.2	40.96	6.1	43.31	5.7
(d) after 15 years	19.73	3.3	20.70	3.3	21.51	3.3	24.10	3.2
Total of 1 and 2	624.62	100.0	626.97	100.0	669.14	100.0	755.12	100.0

* Amounts represent face values.
** See footnote, Table 4.12.

Source: *Trend and Progress of Banking in India*, Reserve Bank of India, 1965, p. 13.

group suddenly dropped from the high level of 45.5 in 1964 to 21 per cent in 1966, whereas the percentage of investment in securities of maturity period of 1–5 years rose from 36.6 in 1964 to 60.5 per cent in 1966. This increase was gradual at first but very fast during 1965 and 1966. Again, the percentage of investments of above 20 years' maturity has also come down to 2.6 in 1966 from 3.1 in 1964 reflecting the banks' disinclination for long-dated securities.

The explanation for a shortening of the maturity pattern may be found in the banks' expectations about the rise in the interest rate in the future; it has been slowly rising since the beginning of the planned economy—a feature quite normal in a developing economy. Also, a change in the pattern of investment behaviour was partly due to the pursuance of a restrictive credit policy introduced in the beginning of the First Plan in 1951. With the raising of the bank rate in November 1951, banks started switching to short and medium securities. This behaviour of the banking system indicates its disinclination to lock up funds for a long period. It also indicates anticipation by the banking system of better investment opportunities in an expanding economy. The present trend demonstrates a larger demand on bank funds and the banks' willingness and ability to respond to the increasing demand by quickly converting the investment in securities into liquid cash to enlarge investable funds. The increasing preference of the banks for short-term maturities arises also from the fact that during the period of rising prices depreciation in the value of the short-term securities especially is comparatively less. An analysis of investments and the maturity pattern of Government securities during the initial years of the Fourth Plan period, however, reflects a different picture. The large rise in investments during the period 1969–1971 was accompanied by a shift from short-dated to

TABLE 4.12. Maturity Distribution of Investments of Scheduled Banks in Government Securities March 1963–March 1966

(Amounts in crores of rupees)

End of	*No. of Reporting Banks*	*1 Year*	*1–5 Years*	*5–10 Years*	*10–15 Years*	*15–20 Years*	*Over 20 Years*	*Total*
The Third Plan Period (Four Years) Amounts								
Mar. 1963	79	87.06(36.69)	188.5	279.13	51.23	1.04	19.66	626.97
Mar. 1964	79	56.87(19.37)	245.22	304.58	40.96	1.21	20.30	669.14
Mar. 1965	75	21.83(5.31)	430.38	255.50	43.31	1.68	22.42	755.12
Mar. 1966	76	76.73(20.09)	495.93	172.59	51.67	1.99	21.36	820.27
The Third plan Period (Four Years) Percentage								
Mar. 1963	79	13.9(5.9)	30.1	44.5	8.2	0.2	3.1	100.0
Mar. 1964	79	8.5(2.9)	36.6**	45.5	6.1	0.2	3.1	100.0
Mar. 1965	75	2.9(0.7)	54.3**	33.8	5.7	0.2	3.0	100.0
Mar. 1966	76	9.4(2.4)	60.5	21.0	6.3	0.2	2.6	100.0

Sources: (1) *Reserve Bank of India Bulletin*, November 1965, p. 1751.
(2) Figures for 1966: *Reserve Bank of India Bulletin*, December 1966.
Figures in bracket indicate investments in Treasury Bills.

** There is *prima facie* discrepancy in the data published in the *Reserve Bank of India Bulletin*, November 1965 and the *Trend and Progress of Banking in India*, 1965. For reconciliation of discrepancy between Tables 4.11 and 4.12 (marked with asterisks**) relevant extract from Reserve Bank of India's letter No. ED. BD. 4890/BVIII(14)-66, dated 19th November, 1966, to the writer is reproduced below:

	End March 1964	*End March 1965*
	(In percentage)	
1. Treasury Bills	2.9	0.7
2. Less than 1 year	5.6	2.2
3. 1-5 Years	36.6	54.3
	45.1	57.2

long-dated (Table 4.13) Government securities and also from the relatively low-yielding central Government securities to relatively high-yielding State and other approved securities. The maturitywise classification of investments during the closing years, 1972–74, showed a marked shift in favour of medium securities (5-10 years) largely due to investment in the new loans issued by the Central and State Governments during this period. As a result, the proportion of these securities to the total rose substantially over the period from 25.7 to 36.1 per cent while that of all other maturity groups declined.

TABLE 4.13. Maturitywise Distribution of Investments of Scheduled Commercial Banks in Government Securities March 1969–March 1974

(Percentage)

Mar.	*1 Year*	*1–5 Years*	*5–10 Years*	*10–15 Years*	*15–20 Years*	*Over 20 years*	*Total*
1969	17.2	42.6	19.8	15.0	0.3	5.1	100.0
1970	9.9	30.8	28.5	17.4	0.7	12.7	100.0
1971	8.3	25.3	25.1	19.4	1.0	20.9	100.0

Compiled by the author from the *RBI Bulletin* May, 1969 and November, 1972.

TABLE 4.14. Maturity Classification of Investment in Government Securities (Fourth Five Year Plan)

(Amounts in crores of rupees)

As at End March	*Short*		*Medium*	*Medium Long*	*Long*	*Total*
	(Below 5 years)	*(Of which Treasury Bills)*	*(5–10 years)*	*(10–15 years)*	*(over 15 years)*	
1972	465.6	28.0	427.5	422.3	343.8	2,659.2
	(28.1)	(1.7)	(25.7)	(25.4)	(20.8)	(100.0)
1973	523.2	60.2	605.5	587.2	460.6	2,176.6
	(24.0)	(2.8)	(27.8)	(27.0)	(21.2)	(100.0)
1974	558.8	36.6	852.6	515.5	531.6	2,358.6
	(23.7)	(1.6)	(36.1)	(21.9)	(18.3)	(100.0)

VII

Monetary Policy and the Investment Portfolio

Since the beginning of the First Plan in 1951, the Government has become an important source of demand for capital funds. It may, therefore, be interesting to make a passing reference to the role of the Reserve Bank of India is assisting the Government in its programme of borrowings.

A notable feature of the floatation of Government securities is that it is customary for the Reserve Bank to absorb Government loans either because of an inadequate public response or because of its willingness to advance credit without reservation to the Government. In a country like India where the money market is characterised by a seasonal pattern, it is not convenient for the Government either to enter the market with new loans time and again or to keep loans on tap indefinitely. It becomes, therefore, necessary for the Reserve Bank to acquire a reasonable stock of Government securities of varying maturities to meet the requirements of investors all the year round.

From the point of view of the monetary authorities investment in Government securities by the banking system is, of course, important. As the Government's banker, the Reserve Bank of India is responsible for the management of public

debt. As a bankers' bank, it is expected to buy and sell securities to meet the short-term needs of the banks and to absorb their excess reserves. As a regulator of credit it is the duty of the Reserve Bank to avoid excessive monetary expansion and to maintain an even keel in the monetary economy. The planned economy of India revealed the conflicts inherent in performing cach of these functions adequately and the necessity of subordinating some functions to those of higher priority.

With the rising tempo of developmental activities in the planning era accompanied by an increasing demand for bank credit from the private sector, banks were placed in a dilemma between investments and loans and advances. On the one hand, they could not turn down the customers whose demand for credit appeared reasonable and profitable and, on the other, they could not ignore the directives of the Reserve Bank of India which insisted that the bankers maintain a traditional ratio of Government securities to deposits. The policy of the Reserve Bank will largely determine a bank's behaviour to switch from one asset to another. The more restrictive the policy of the Reserve Bank is the more difficult it will be for the commercial banks to adjust their portfolios.

The purpose of splitting the cash reserve ratio and the liquid assets ratio is to prevent banks from selling Government securities in response to the tight monetary policy. A suggestion has been offered to empower the Reserve Bank to fix a supplementary Government Securities Ratio Requirement[16] to strengthen the hands of the central bank in rendering the monetary policy more potent and effective. Under the scheme while commercial banks have to maintain a statutory percentage of their demand and time liabilities with the central bank, they may also be required to maintain supplementary reserves in Government securities, treasury bills and other approved assets amounting to a stated percentage[17] of any increase in their deposit liabilities after a specified date. The significance lies in the fact that it fixes an upper limit to bank credit-deposit ratio.

We have, however, a different opinion on this point. A growing economy needs a larger amount of credit for meeting its diversified demands. The Supplementary Reserve Ratio scheme, we feel, will unduly hinder production which is so urgently needed to stimulate growth. Further, this suggestion if translated into action will have the effect of virtually converting the banking system into a state of bondage.

The Supplementary Reserve Requirements procedure may also be criticised on the same grounds as the usual variable reserve ratio is—that under it the Government would be provided with a cheap way of borrowing. Instead of obtaining their requirements from the central bank, they can get what they want from the commercial banks by ensuring that their own obligations will be held by them. Incidentally, it may be pointed out that in Australia, the liquidity

[16] *The Management of Public Debt in India*, National Council of Applied Economic Research, New Delhi, 1965, pp. 91–96 and 116. The Council has suggested this ratio at 10 per cent on total deposits.

[17] Basu, S. K., *A Survey of Contemporary Banking Trends*, The Book Exchange, Calcutta, 1965, p. 136.

ratio of 25 per cent introduced in 1953 was reduced to 14 per cent.[18] The monetary authorities must realise that the liquidity ratio should be determined in such a way that the momentum for expansion is not halted. In view of the *bonafide* requirements of the credit needs of the private sector in a mixed economy, the central banker while fixing the liquidity ratio must also keep in mind the growing financial needs of the developing economy.

VIII

Highlights of the Survey of Investment of Scheduled Commercial Banks during the Fourth Plan Period

The larger increase in the growth of investments from Rs 1,285 crores in March 1969 to Rs 1,587 crores in March 1970 to Rs 2,289 crores in March 1972 and Rs 3,407 crores in 1974 may be attributed to the faster growth in deposits and stepping up of the statutory liquidity ratio (SLR). This action was taken by the Reserve Bank in the light of the credit and price situation and in the context of the need for increasing investments of banks in Government and other approved securities during the Fourth Five Year Plan. The pattern of investments showed a marked shift in favour of other trustee securities from Rs 318 crores (20.0 per cent) in March 1970 to Rs 550 crores (24.0 per cent) in March 1972 and further to Rs 940 crores (27.6 per cent) in March 1974. As in the First, Second and Third Plan, investment in Government and other approved securities constituted the bulk of the total investments (over 96 per cent) during the Fourth Plan. The composition of investments in the Central and State Government securities reveals that despite the increase in investments, their relative share in total investments showed a decline from 79.1 per cent as on March 31, 1969, to7 5.7 per cent on March 31, 1970, to 73.9 per cent on March 31, 1971, to 72.5 per cent on March 31, 1972, and further to 70.0 per cent on March 31, 1974. This is due to the fact that the banks had to invest in debentures and loans floated by the new and expanding public development institutions.

Another striking feature is the absence of investment in Treasury bills by the Indian scheduled banks. This may be attributed to two factors; the tight resources position of these banks and the high rate of interest prevailing in the call money market. While many Indian banks did not have surplus funds of a short-term nature, those which had surplus funds preferred to deploy them in inter-bank lending. As against this, the increase in securities reflects the liquidity requirement as stipulated by the Reserve Bank.

The scheduled commercial banks' support to the loans floated by the Central and State Governments in 1970-71 was quite satisfactory. The maturitywise classification of investments showed a marked shift in favour of securities of over 10 years. Scheduled commercial banks' investments in short-dated securities (below 5 years) declined from 59.8 per cent at the end of March 1969 to 40.7

[18] Olakanpo, op.cit., p. 83. According to Annual Report, 1960 the present ratio is 16 per cent.

at the end of March 1970 and further to 33.6 at the end of March 1971[19]. During the latter part of the Fourth Plan (1972–74) a reverse trend was noticed and investments recorded a marked shift *in favour of medium-short* securities (5–10 years) quite in conformity with the inflationary price level which was galloping by leaps and bounds. This trend is also due to the investments in the new loans policy of the Government. Investments in other trustee securities showed a marked rise. This may be attributed to the advice given to the banks by the Governor of the Reserve Bank of India in1969 that they should utilise their liquid resources in the slack season for investment in longer-dated trustee securities.

IX

Observations

From the preceding analysis, it appears that if commercial banks are given the freedom to choose between Government securities and private loans, it is almost certain that the latter would be preferred to the former for obvious reasons—better yield and greater freedom of activity. Further, a rise in the interest rate on loans may add to the profit of a bank which itself provides incentives to banks and stimulates the growth process, and is seldom found in the investment in Government securities.

Again, as a rising credit ratio generally goes with a declining investment ratio, it has been proposed to levy a tax on bank advances.[20] We can hardly subscribe to this proposal, because of its possible psychological effect on bankers and their clients. Secondly, in view of the growing demand for credit, the tax would be an oppressive burden on the borrowers who would obviously pass it on to the consumers through the process costing of production and this will hit at the root of the objective of planned economy. The monetary authorities should give due attention to this point.

Under the new regulations, the Reserve Bank has been empowered to raise the overall liquidity ratio upto the limit of 48 per cent (33+4-15 per cent) of aggregate deposits whenever necessary. It is admited all-round that the banking structure has been consolidated and strengthened by virtue of the wide and sweeping powers vested in the Reserve Bank of India by the Banking Regulation Act. The Deposit Insurance Act has further injected confidence in the minds of the depositors for the country's banking sector. We do not, therefore, conceive of a real necessity for the 33 per cent requirement to be imposed on the banking system as a whole. It may be recalled that percentage was only 20 before September 1964. This compulsion would be too harsh for the banks to supply credit to the productive sector. Secondly, this legislation ignores the differences between small and big banks. The Reserve Bank of India's policy must be pursued in such a way as to guide the banking system to contribute to the growth objective.

[19] *Reserve Bank of India Bulletin*, November 1972.

[20] *The Management of Public Debts in India*, op. cit., pp. 85–87.

There are many elements of unsoundness of investments in Government securities. First, the yield differential between Government investment and private securities has tended to widen. The annual average yield of debentures, preference shares etc. has gone up substantially unlike the meagre yield on Government securities. This characteristic as well as inflationary conditions tend to bring about a progressive depreciation in capital values. It may be called the erosion of capital—a feature which offends the principle of capital formation which is needed to boost the economy of India. The longer the maturity pattern of securities, the greater is the capital loss. We may, therefore, suggest that, in view of the growing demand for credit in a developing economy, the traditional statutory requirements for investments in Government securities should go. All in all, banks acquire Government securities in excess of their liquidity requirements only when the demand for loans is at a low level. In the new set of circumstances, the demands and expectations placed on the banking system are also changing. The Reserve Bank of India should remodel its policy and refine its tasks so that commercial banks, instead of locking up their funds in less productive Government investments, can invest their resources to meet the ever increasing credit needs of the growing economy. The present legislation which compells commercial banks to invest 33 per cent of their resources in low-yielding securities unnecessarily restrains the credit behaviour of the banks. The present policy thus unwisely restricts the expansion of bank credit which could have been directed to the needs of the expanding economy. Low-yield Government securities are not as attractive to banks during prosperous periods as higher-yielding private loan paper.[21]

The public sector banks, the Life Insurance Corporation (LIC) and the Provident Fund together account for 85 per cent of the securities held by the public. Most of these institutions invest in securities only to hold them until maturity. The Reserve Bank of India plays an important part in the market both at the time of new issues and subsequently. The open market operations of the Reserve Bank have to be interpreted carefully because of the Bank's policy of acting as an underwriter at the time new issues are offered. In general, the open market operations have been used in India more to assist the Government in its borrowing operations and to maintain orderly conditions in the Government securities market than for influencing the availability and cost of credit. An essential promotional function of a central bank in the development context is the nurturing of a broad-based securities market; the limitations of an open market policy stem, in a situation such as in India, more from the structural need to build up an active bond market and the more immediate requirements of assisting the Government in its borrowing operations and these militate against a reliance on these operations for credit control purposes.[22] The total volume of transactions among the constituents of the market is very limited. The Reserve Bank of India is not ready to take the Government securities at a given price. It allows the price to fluctuate with changes in interest

[21] Timberlake, Jr., op. cit., p. 126.
[22] *Reserve Bank of India Bulletin*, April 1966, p. 350.

rate. However, it does support securities at prices decided by it. In fact, it is this readiness that imparts liquidity to the Government securities in India. Marketability in the Indian context implies transferability to the Reserve Bank.[23]

If one assumes that public investment has a higher 'social benefit' than private investment, such a diversion can be justified. But another problem remains—of how to estimate the liquidity of an asset which forms part of a legal requirement. When assets are frozen, can one legitimately claim that there is still liquidity? It is interesting to note that in the USA, even though there is no secondary reserve requirement, banks have maintained 25 and 30 per cent of their deposits in Government and State Government securities. The requirements of liquidity have compelled banks to hold these securities even though the return on Government securities is less than that on loans (see Annexure, p. 117). In India, the difference between return on loans and interest on Government securities has been much greater than that in the USA. The primary reserve requirement in India is only 4 per cent of total deposits whereas it would have been between 15–18 per cent in the USA. The capital deposit ratio is half of what it is there (Table 12.2A). Taking all these factors together one is led to believe that if Government securities in India did possess the kind of liquidity which they command in the USA banks here, too, in the normal course would maintain around 25–30 per cent of deposits in Government securities.[24]

[23] Sametz, A. W., Ed., *Financial Development and Economic Growth*, New York University Press, 1972, pp. 162–185.

[24] Ibid. pp. 176–177.

Annexure 4.i

Rate of Return of Loans and Investments

(Percentage)

	INDIA		*UNITED STATES*	
	Investments	*Loans*	*Investments*	*Loans*
1950	2.4	4.6		
1955	2.7	4.8		
1960	3.2	5.33	3.14	5.92
1961	2.9	6.1	3.05	5.84
1962	2.9	6.45	3.22	5.93
1963	3.00	6.58	3.38	5.87
1964	3.22	6.67	3.63	5.88
1965	3.21	7.77	3.69	5.85
1966	3.61	8.1	4.02	6.24
1967	3.76	8.3	4.48	6.39

Sources: Statistical Tables Relating to Banks, 1964, 1967. *Federal Reserve Bulletin* (1963–1967).

5

The problem of Economic Growth with Stability

Conflict and Incompatibility among Objectives—Inflation as an Instrument for Accelerating the Rate of Investment

Since the present work is concerned with the central banking policies and operations in the Indian context, an analysis of the problem of economic growth with stability seems appropriate at this stage. The fundamental objective of economic policy in India, as in many other growing nations, is promotion of economic development with stability. In specific terms, this means the promotion and maintenance of a rising level of production and real income and the attainment of reasonably full employment, together with financial stability. Financial stability, in its turn, comprises domestic price stability as well as exchange stability, with an approximate equilibrium in the balance of payments, taking into account the movement of capital. No economy can attain completely all of these objectives simultaneously except by sheer coincidence.

The possibility of conflict and incompatibility among the different objectives is ever present. The promotion of the full development of the productive resources of the economy may be inconsistent with the preservation of domestic monetary stability and, consequently, may strain the exchange equilibrium as well. Equally, excessive concern with the maintenance of price stability and exchange equilibrium may jeopardise economic expansion. Any attempt to push too far one objective at the cost of another may cause intolerable strain to the body politic and may even disrupt society.[1]

In accepting the achievement of economic development with stability as the aim of monetary policy, the question arises whether inflation is necessary or helpful for development. It is commonly believed that a degree of inflation acts as a stimulus to development owing to the greater relative growth of profits than of wages under a slowly rising price level, and the consequent increase in the proportion of savings or investment, relatively to that of consumption, to national income. On the other hand, a good deal of evidence has been adduced

[1] The Radcliffe Report, paras. 69–70.

in favour of the conclusion that economic development is associated with conditions of comparative stability rather than persistent inflation. Of course, there is no instance of absolute stability of general prices over a long period in democratic countries.[2] By and large, there is a consensus among economists that both favourable and unfavourable effects can be expected, depending upon the various factors, including the institutional setup of a country. In order to have beneficial effects on investment, the rate of increase in prices, however, must be slow. Only if the rate of growth of inflation is lower than the current money rate of interest, will the investors be encouraged to invest in longer-term income-yielding assets which are more favourable to growth. In more general terms, inflation might be used as an instrument for accelerating the rate of investment because a slow price rise possesses three distinct characteristics.[3] Firstly, inflation transfers income from consumers or conservative savers to the more dynamic entrepreneurial minority, upon whom the development process depends. Secondly, inflation leads to a fuller utilisation of resources, particularly if there is a surplus of agricultural labour with low marginal productivity that can be shifted to more productive occupations without appreciable reduction of the supply of consumer goods. And thirdly, inflation is easier to impose upon people than taxation. A great many economists, however, feel strongly that inflation is actually detrimental to a sustainable growth in real investment.[4] There are other economists who would not necessarily deny the power of inflation to induce investment, but they maintain that once inflation is accepted by the public, it is difficult if not impossible, to contain it within reasonable limits.[5]

It is not our intention to present here an exhaustive survey of arguments for and against inflation as an instrument for inducing investment. Even if this is done, such a survey will not adequately determine where the balance of advantage lies. Neither can our experience of the process of development in other countries be of great help. Transcending various controversies, we maintain that under a variety of favourable conditions, other things being equal, a slow rate of inflation is likely to step up the rate of real investment.

An inflationary policy designed to stimulate economic development can make important contributions to growth. But this potential cannot be realised if the evils of inflation are not explicitly recognised. Of course, a spiralling inflation must be excluded from this discussion since it serves to retard rather than accelerate development. The evils of inflation are many[6] and they should be recognised and scrupulously avoided if an inflationary policy is to contribute

[2] See speech delivered by Dr. B. K. Madan, former Deputy Governor of the Reserve Bank of India, at the fifth SEANZA central banking course held at Karachi during January–March, 1964.

[3] Campos, R. de Oliveira, "Inflation and Balanced Growth", in Howard S. Ellis and H. D. Wallich, Ed., *Economic Development for Latin America*, Proceedings of Conference held by International Economic Association, St. Martin's Press, New York, 1961, p. 86.

[4] Shaalan, A. S., "The Impact of Inflation on the Composition of Private Domestic Investment", *IMF Staff Papers*, Vol. IX, No. 2, July 1962, p. 246.

[5] Domar, Evesy D., *Essays in the Theory of Economic Growth*, Oxford University Press, New York, 1957, p. 115.

[6] Chandler, Lester V., loc. cit., pp. 36-43.

to capital formation, efficiency and growth. The inflation that we have so far emphasised is of the initial impulse type, as distinct from the spiral process. Inflation of the former type generated as a deliberate policy of growth must be self-liquidating within a given period of time. If this is not the case, the initial inflation will invariably start the spiral process signifying that the economy is sick rather than growing.

Thus, one of the most important alternatives open to growing nations is to resort to inflation as a deliberate policy for the long-term objective of rapid economic growth. Implicit in this is the fact that the generation of inflation in the initial stages requires a big push by the Government with careful planning for the optimum use of limited resources. This is true in spite of the handicap from which many underdeveloped countries suffer—that of an inefficient administrative organisation as well as inadequate fiscal and monetary machinery.

II

Significance of the Regulatory Role in Deficit Financing

In developing nations the root of most of the inflationary disorders lies in a deficit in the Government budget which is financed by the creation of new money. With a view to stepping up the rate of investment relative to available savings, the Government has a tendency to overextend its position beyond its normal capacity. Once the targets of development are set, the problem of mobilising necessary finances arises. A possible solution to this problem lies in a country's ability to attract foreign loans. The need for borrowing is reduced to the extent that the Government can secure external assistance. However, these are largely political matters. There are again, almost always, limitations to the collection of sufficient revenues. The tax structure may be inadequate or the tax laws may not be enforced effectively. Besides, the institutions for collecting money savings of the people in India, for example, are undeveloped and rudimentary. The credit of the Government in many cases, also, may not be securely established. Finally, the currency might be depreciating so that no fixed obligation stated in the currency might be easily saleable. If, then, the Government still decides to implement its developmental plans, it is forced to demand of the central bank the creation of new money since that is an easier way and, perhaps, the only available form of expanding money. An inference that can be drawn is that the central bank has a very difficult role to play when the Government initiates the process of inflation for accelerating development. On the one hand, the central bank must assist the Government in its programme of deficit financing to ensure that the initial inflation is successfully generated. On the other hand, it must keep constant vigilance over the vulnerable economy so that it does not develop into a galloping inflation. So, the control of inflation should be one of the major objectives of economic policy in a developing economy.

The above analysis discloses that if the less developed nations decide to bring about rapid growth with the help of deficit financing and the Governments of

these countries are constrained to rely heavily on central bank credit, the regulatory function of the monetary authorities assumes special significance. This is simply because such countries do not fancy just any kind of growth, but only that growth which is attainable with a certain degree of stability. It is appropriate to mention here that the scope of monetary policy in underdeveloped countries is different from that in developed nations for two distinct reasons. Firstly, in most of these countries money supply primarily consists of currency in circulation, while bank deposits form a relatively small portion of the money supply as compared to the ratio of demand deposits to money supply in the Western nations. Secondly, the community is not very familiar with the use of credit instruments and there is an absence of any broad organisation of agencies to distribute finance to those who need it for investment purposes. This lack of deposit habit on the part of the people makes it difficult for the central bank to influence the economy by controlling the banking system.

While a great many economists would effectively argue the case for an active monetary policy, there are others who are of opinion that monetary policy at best should play only a passive role. The economists who are strong in their conviction as to the active role of monetary policy in the context of growth, argue that monetary policy must be used to provide the correct amount of money consistent with higher levels of economic activity. Therefore, one of the major tasks of the monetary authorities in development should be to support the gradual expansion and diversification of the machinery—commercial banks, savings banks, investment banking, insurance companies, the Government bond market, private bond and share markets, etc., which links surplus and deficit spending units. The monetary authorities must also keep watch over the expansionary phase with vigilance "to keep inflationary pressures at bay while the production forces are gathering momentum".[7] The role of the Reserve Bank of India in the present situation is to reduce the pressure of monetary demand without hampering production. In other words, money must be made tight but not at the expense of production, for that would be self-defeating. This objective has previously been sought to be achieved by a variety of measures—by an exhortation to banks to reduce overall credit, by reducing the Reserve Bank accommodation to the banking community and by regulating credit to specific sectors of the economy or what is called selective credit control. These measures have had rather limited success and, more recently, the Reserve Bank of India has attempted another technique. As the authorities wanted to ensure that credit was available for genuine productive purposes and also that its use was not extravagant, the Reserve Bank decided that banks would get accommodation from it at the bank rate only up to limited amounts on the basis of quotas fixed on a uniform basis and beyond that at a higher cost (for details see Chapter 2). The Reserve Bank also ensured that all banks—and not merely those that borrowed from it at penal rates—made their credit to their clients more expensive. Quite clearly, the immediate cost to productive enterprise would rise as a result of dearer money. The expectation is that dearer money would

[7] Iengar, H. V. R., *Monetary Policy and Economic Growth*, Vora & Co., Bombay, 1962, p. 162.

also reduce the demand for credit for nonproductive purposes, for instance for speculation on the stock exchanges and commodity markets.

With the rise in the wholesale price index of 14.8 per cent to 158.6 over the year in 1964 (1952-53=100), the bank rate was raised from 4.5 to 5 per cent on September 25, 1964. The system of quotas and slab rates was replaced by a new controlling device by which the borrowing power of the bank was related to its net liquidity position (28 per cent). Contrary to expectations, the pushing up of the bank rate did not prove adequate in controlling the inflationary pressures. The wholesale price index was 16 per cent higher in February 1965 than the previous year. So, on February 17, 1965, the bank rate was raised again by one per cent to make it six per cent. It indicated a definite emphasis on dearer money policy and demonstrated Reserve Banks' growing concern over the price trend. The announcement was accompanied by a directive which raised the required liquidity ratio to 30 per cent as against 28 per cent under the September 1964 Scheme.[8] Evidently the objective of control of access right by the new device of higher liquidity ratio requirements was to neutralise a part of the potential liquidity of the banking system and to limit the expansion of bank credit. On the whole the effect, combined with that of the other monetary measures taken, should be to exercise a downward pull on inflationary pressures. Only in this way can the less developed nations achieve a sustained growth.

There are a large number of economists who believe that all roads pointing to economic development lead to inflation anyhow. This scepticism stems not so much from the inherent limitations of monetary policy as from the belief of many responsible leaders that inflation is a useful or indeed an indispensable stimulant to the economy and that progress can invariably be accelerated through a kind of forced saving. A reaction against this preference for inflationary financing has led many economists to emphasise stability rather than growth. The achievement of stability, according to them, brings growth as a by-product. The duty of the authorities, therefore, should be to ignore, or pay only slight attention to, the requirements of growth and to concentrate on stability.[9]

III

Short-term Objectives versus Long-term Objectives (Regulatory versus Promotional Role)

When the Government decides to pursue the inflationary method of financing development, monetary policy is charged with the responsibility of controlling the new inflation generated in the economy. This might be called the restrictive role of monetary policy—the short-term objective of controlling inflation. Besides this restrictive aspect, monetary policy has an additional and perhaps

[8] For details see Chapters 2 and 3.

[9] Ellis, H. S., Commenting on C. R. Whittlesey, "Relations of Money to Economic Growth", *American Economic Review*, Papers and Proceedings, XLVI, May 1956, pp. 206–10.

more important role to play—the promotional role. The promotional role of monetary policy—the long-term objective—relates to the inducement of savings and investment through the development of monetary and credit institutions, improvement of the technique of control, monetisation of the market, training of personnel and enlargement of the scope of monetary policy in every possible way. In the ultimate analysis the effectiveness of monetary policy in its former role would mainly depend upon the success with which it performs its promotional role.

It was observed earlier that if the Government of a country deliberately resorts to the method of deficit financing in order to maintain or accelerate the rate of development, and thereby subordinates monetary policy to fiscal policy, the central bank has no choice but to act as a credit creating machine for the Government. However, the central bank still assumes the responsibility of controlling the resultant inflation by pursuing an appropriate monetary policy. The Government of India was compelled to resort to deficit financing for the implementation of the Five Year Plans, the sizes of which were disproportionately large in relation to the available resources. The Reserve Bank of India, the central bank of the country, was called upon to help the Government in the successful implementation of the Plans. It had no other alternative than to open the monetary tap so as to make the central banking policy consistent with the total economic policy.

IV

Monetary Implications of Deficit Financing

The monetary implications of deficit financing may now be examined. The immediate result of deficit financing is to create additional currency or credit. This additional purchasing power enables the Government to outbid consumers in the procurement of resources and use them for capital formation. As a result the money supply rises, and is accompanied—perhaps with a time lag—by a shortage in the availability of consumer goods. The combined effect of these is, frequently, generation of inflation in the economy. This does not necessarily suggest that deficit financing for capital formation is always inflationary. In fact, to a certain degree the expansionary character of deficit financing does satisfy the currency and credit needs of a developing economy. As an underdeveloped country grows, there arises a definite trend towards a greater demand for financial assets with the enlargement of money and capital markets. Another way of stating this fact is that through the process of development, monetisation of the economy becomes the cause of increased non-inflationary demand for money. It would thus appear that an increasing percentage of money supply to national income is, within limits, not only desirable but also a concomitant of a higher level of economic activity. Even though an increase in money supply may not be accompanied by a corresponding increase in production, a larger volume of money supply than hitherto maintained is consistent with rapid economic development. This is because a certain

degree of inflation is inherent in the very process of development.[10]

The above view can be partly substantiated by the experiences of many nations which realised rapid economic growth like the USA where the rate of money expansion during the periods of rapid economic growth was faster than the rate of growth of output. Professor Hansen[11] has shown that in the USA

> ...the money supply in 1947 was 60 per cent larger (relative to income) than in 1900, and 120 per cent larger than in 1880; eight times as large (relative to income) as in 1820, and sixteen times as large as in 1800.

Similar trends have been noticed in the UK by A. E. Fearveryear.[12] And the same holds true for Germany, Japan and the USSR for the hectic decades of their rapid economic growth.[13] Such pragmatic studies have not been made in the underdeveloped countries.[14] Nevertheless, generally in current literature there are two strong arguments in support of monetary expansion for financing developmental and growth activities in these countries.

The first line of argument owes its inspiration to the experience of economic development under capitalist enterprise and is called the self-liquidating thesis. It is argued by the economists belonging to this group that when development projects are to be undertaken, if adequate voluntary private savings are not available, a part of the investable funds can be supplied through the creation of money. Creation of credit for developmental purposes may not always become purely inflationary. Inflation for the purpose of creating useful capital is often self-destructive. As Professor Lewis[15] asserts,

> ...inflations which are used to create useful capital are self-destructive, in the sense that in due course the new capital produces a new stream of consumer goods which either checks the rise of prices, or even brings price down.

Further, according to Professor V. K. R. V. Rao, it would be unwise to maintain that the creation of money for real investment will always result in true inflation; much would depend on the amount of money created, variations in cash holdings, the amount of marginal income saved, and changes in the volume of output.[16] Nevertheless, the ultimate success of this policy would rest upon the ability of the authorities to keep the inflation within safe limits and also to increase the output within a reasonable time.

The second argument relates to the so-called employment thesis. It is asserted by the advocates of this thesis that the fundamental economic problem faced by the underdeveloped countries is not merely that of development, but it is also

[10] Khatkhate, D. R., "Impact of Inflation on India's Economic Development", *Economic Development and Cultural Change*, Vol. VII, No. 3, Part I, April 1959, p. 363.

[11] Hansen, Alvin H., *Monetary Theory and Fiscal Policy*, McGraw-Hill Book Company, Inc., New York, 1949, p. 6.

[12] Fearveryear, *The Pound Sterling*, Oxford University Press, London, 1931, pp. 91–108.

[13] *Indian Journal of Economics*, July 1956, p. 126.

[14] A statistical study made by a member of the IMF concludes without sufficient proof that among underdeveloped countries the rate of growth of the economies studied was higher when the rate of inflation was lower.

[15] Lewis, *The Theory of Economic Growth*, Richard D. Irwin, Inc., Illinois, 1955, pp. 217, 244.

[16] Rao, V. K. R. V., "Deficit Financing, Capital Formation, and Price Behaviour in an Underdeveloped Economy", *Eastern Economist Pamphlets*, 1953, pp. 16–17.

one of employment, since most of these countries have surplus manpower which must be provided with employment. In underdeveloped areas transfer of surplus manpower from agricultural industry to other industries only leads to a monetary expansion without a corresponding decline in agricultural output. This is due to the fact that the marginal productivity of the surplus manpower in the agricultural industry is very low, sometimes even negative and its removal from this industry does not materially affect the total productivity. Thus, if money is created to pay for the workers to be shifted to more productive activities, prices will rise moderately in the initial stage. At a later stage, when output increases prices will fall back to a lower level and the equilibrium will be restored. Incidentally, it may be pointed out that this approach owes its inspiration to the experience of the USSR.[17] The United Nations also believes that there are two distinct possibilities for financing capital formation by creating money. The first possibility is, if capital equipment could somehow be found, to employ some of the unemployed and underemployed persons, and if new money were then created to pay their wages in producing consumption goods, then those workers would save part of their income, and their money savings could be used to pay additional workers to produce capital goods.[18] Secondly, as developing nations grow, the demand for money increases steadily even when no inflation occurs, either because of the growth of national income or because of the increased monetisation of the economy. Under these circumstances people will increase the proportion of assets held in the form of financial instruments—if the authorities are able to convince them that any inflation that is generated in the economy will be effectively controlled. If the authorities are successful, the financial sector will gradually expand. This gradual increase in financial assets will progressively increase the savings (money) power of the community. Increased savings of the community represent, at least in part, an annual addition to the borrowing power of the Government which can be conveniently used to finance capital formation.[19] All these arguments lead to the same conclusion—that an increase in money supply, within limits, is not only consistent with, but also a prerequisite of an accelerated programme of economic development.

If the Government wishes to divert an increasing proportion of the economy's resources to its own uses, and is unable to increase taxes beyond a certain level, it can do so either by the creation of money or alternatively by borrowing money from the private sector or the banking system—mainly from the central bank thereby increasing the public debt. In the case of a developing country, the scope for taxation beyond a certain level and borrowing large amounts from the public are limited. Consequently, in many instances the Government is left with no choice other than to resort to bank credit. Borrowing from the

[17] Dobb, Maurice, *Some Aspects of Economic Development*, Occasional Papers (No. 3), Delhi School of Economics, Delhi, Privately Printed, 1951.

[18] It is assumed that the marginal propensity to consume is less than unity and that the marginal savings of these workers could be successfully mobilised.

[19] *Measures for the Economic Development of Underdeveloped Countries*, United Nations New York Sales No. 1951, II, B. 2, 1951, p. 43.

banking system results in an expansion of credit. The Government usually meets the responsibility of expanding money supply through the central bank of the country which can, within limits, be directed to assist the Government in this task. It is conceivable that the central bank may face the restriction of resources which must be legally maintained by it against note issue. In such circumstances the Government may still circumvent the obstacle by delinking foreign reserves from note issue and thereby pave the way for smoother monetary expansion. Under the traditional monetary systems expansion in currency was invariably linked with the accumulation of gold or foreign exchange as a monetary reserve. Even with a more flexible monetary system, most countries base their currency expansion on some type of Proportional Reserve System. This system also sets a limit to the Government's power of money creation. The Government can, however, still expand money supply beyond the legal limit if the Proportional Reserve System is replaced by some type of Minimum Reserve System. This was done in India in 1956, for instance, to enable the monetary authorities to create credit to finance the Five Year Plans.

V

Some Aspects of Deficit Financing in India

The First Plan was basically an agricultural Plan, a considerable percentage of the Plan outlay was spent for strengthening agriculture. Domestic production increased. Inflationary tendencies were eliminated. Investment in the economy was also stepped up, for which some financial resources were provided by deficit financing. However, in the absence of a bumber crop or adequate availability of food supplies, deficit finance may become injurious to economic growth and stability.

It is in these circumstances that the gigantic Second Plan commenced having an outlay more than double that of the First Plan. Deficit financing constituted 20.4 per cent of the public sector outlay during the Second Five Year Plan (Rs 945 crores) as against 17 per cent during the First Five Year Plan (Rs 333 crores). The peculiar characteristic of the Second Plan which should be noted from the viewpoint of deficit finance, was a special emphasis on the development of basic and heavy industries. It is a natural corollary that the expenditure involved in basic and heavy industries flowed to urban sectors which are provided with banking services. Deficit finance undertaken for such heavy industries in urban areas naturally will percolate quickly to the banking system in the form of deposits and will enlarge the base for credit creation.

There was a continuous rise in the indices of the cost of living, prices of food articles and wholesale prices during the Second Plan period. The cost of living in 1960–61 rose by 29.2 per cent and the wholesale price index rose by 35 per cent over 1955–56. These trends contrast with those in the First Plan period particularly in the latter part, when, it may be recalled, there was a noticeable fall in the indices of the cost of living, prices of food articles as well as wholsesale prices. Tables 5.1 and 5.2 give the amount of deficit financing and related economic data during the First Plan and Second Plan periods.

TABLE 5.1. Deficit Financing and Related Economic Data First Five Year Plan, 1951–56

Year	*Deficit financing (Rs in crores)*	*Money supply with the public (Rs in crores)*	*Percentage of deficit financing to money supply*	*Cost of living (1949 = 100)*	*Index Number of prices of food articles* (1952-53 = 100)	*Index Number of Wholesale Prices* (1952-53 = 100)
1951-52	2	1,848	0.11	105	111.4	118.0
1952-53	45	1,785	2.52	104	100.0	100.0
1953-54	36	1,857	1.94	106	100.1	104.6
1954-55	93	1,981	4.69	99	94.6	97.4
1955-56	157	2,217	7.08	96	86.6	92.5

Sources: *Report on Currency and Finance,* 1957-58 and 1958-59.

TABLE 5.2. Deficit Financing and Relating Economic Data Second Five Year Plan, 1956-1961

Year	*Deficit financing (Rs in crores)*	*Money Supply with the public (Rs in crores)*	*Percentage of Deficit Financing to Money Supply*	*Cost of living* (1949 = 100)	*Index Number of Prices of Food articles* (1952-53 = 100)	*Index Number of Wholesale Prices* (1952-53 = 100)
1956-57	253	2,342	10.80	107	102.3	105.3
1957-58	497	2,413	20.60	112	106.4	108.4
1958-59	140	2,526	5.54	118	115.2	112.9
1959-60	112	2,720	4.12	123	119.0	117.1
1960-61	49	2,869	—	124	120.0	124.9

Source: *Report on Currency and Finance,* 1960-61.

During the Second Plan period, deficit financing was undertaken in an unplanned manner, without linking the volume of deficit financing year by year to any specific criteria. The short-fall in resources raised through taxation, borrowing, etc. was made good by the creation of additional money. This tendency was aggravated due to an increase in nondevelopment expenditure and the failure of food crops. The adverse effects on the economy were, to an extent, offset by imports under PL 480 which began in 1956. However, the increasing quantum of deficit financing in the last two years of the First Plan and first two years of the Second Plan began to filter down into the banking system and enlarged the credit base of banks.

When deficit finance of huge amount[20] is undertaken year after year, it is natural that it will push up indices of the cost of living as well as prices of food and other articles. On top of a 29.2 per cent rise in the cost of living in the Second Plan, India experienced an additional increase of 36.3 per cent over the Third Plan period. The price rise was severe in the case of food articles as it

[20] Rs 1,151 crores, Rs 682 crores, Rs 1,066 crores and Rs 1,000 crores in the Third Plan, Annual Plans (1966–69), Fourth Plan and the Fifth (1974-79) Plan (Draft) respectively.

jumped by 40.7 per cent between March 1961 and 1966, over and above 38.6 per cent in the preceding five years (March 1956–1961). It is well known that the propensity to consume food in a low-income country like India is very high. About 60 per cent of the average per capita income is spent on food, that is, cereals, pulses, etc., which are not always sufficient to provide full and rich nourishment. Also, in the wholesale price index food articles have been given a weightage of 504 points; the rise in the prices of food articles will naturally push up the index number of wholesale prices. Major industrial raw materials are also supplied by the agricultural sector and deficiency in their supply will also contribute to push up wholesale price index. Thus, the net result was that wholesale price index moved very close to the index of prices of food articles—the former went up by 32 per cent over the span of five years, from March 1960–61 to 1965–66. Unfortunately, this phenomenon continued over the next two years even after the end of the Third Plan. Table 5.3 gives the amount of deficit financing and related economic data during the Third Plan, 1961–1966. The

TABLE 5.3. Deficit Financing and Related Economic Data
The Third Five Year Plan, 1961–1966

Year	*Deficit Financing (Rs in crores)*	*Money supply with the public (Rs in crores)*	*Percentage of Deficit Financing to Money Supply*	*Cost of Living (1949 =100)*	*Index Number of Prices of Food Articles (1952-53=100)*	*Index Number of Wholesale prices (1952-53=100)*
1961-62	184	3,046	6.04	127	120.1	125.1
1962-63	183	3,310	5.53	131	126.1	127.9
1963-64	211	3,752	5.62	137	136.8	135.3
1964-65	188	4,080	4.61	157	159.9	152.7
1965-66	385	4,530	8.50	169	168.8	165.1

Source: *Report on Currency and Finance,* Reserve Bank of India, 1966–67.

economic situation, as a result of persistent doses of deficit finance and severe drought in 1966–67, became almost explosive and forced the Government to undertake a devaluation of the rupee in June 1966, the second after independence. The magnitude of this devaluation was as large as 36.5 per cent; it had earlier been devalued in 1949 by 30.5 per cent as a consequence of the extraordinary rise in prices due to the after effects of World War II. The situation which developed in 1966 after fifteen years of planning was very similar to the first. Nevertheless, there was asymmetry since the first devaluation occurred due to war, and the second one was occasioned by development efforts. Growth with stability should be our watchword in the years to come so as not to endanger again the value of our currency.

The most serious evil of deficit financing is that it is intrinsically inflationary in character and causes a rise in prices by increasing the total volume of money supply and raising the aggregate demand for goods and services in the absence of a corresponding increase in the supply of goods and services.

Table 5.3A gives a complete picture of deficit financing, money supply with the public, and the index number of prices in the Fourth Plan period. It is evident that there was an unprecedented rise in the index number of wholesale prices and food articles during this period. In fact, there has been an upsurge of about 50 per cent in prices between 1969 and 1974. During 1972-73 the wholesale price index increased by more than 9.5 per cent and in 1973-74 the wholesale price index soared by as much as 22.7 per cent,* —the steepest rise on record for the Indian economy.

TABLE 5.3A. Deficit Financing and Related Economic Data Fourth Five Year Plan, 1969-1974

Year	*Deficit Financing Rs in crores (At Current prices)*	*Money supply with the public (Rs in crores)*	*Percentage of Deficit Financing to Money Supply*	*Cost of Living* (1960=100)	*Index Number of prices of Food Articles* (1961-62=100)	*Index Number of Wholesale Prices* (1961-62=100)
1966-69 (Annual Average)	227	—	—	—	—	—
1969-70	58	6,387	0.91 (Approx.)	177	196.8	171.6
1970-71	365	7,140	5.11	186	203.9	181.1
1971-72	383	8,138	4.71	192	210.3	188.4
1972-73	175	9,412	1.86	207	239.5	207.1
1973-74	85	10,836	0.78	250	295.6	254.2
Fifth Plan 1974-79 (Annual Average)	200	—	—	—	—	—

Source: Compiled by the author from the Reserve Bank of India publication.

During the 1950's the money supply with the public went up by 42 per cent but in the 1960's it increased by 150 per cent. Alarmingly, during the Fourth Plan period (1969-74) the money supply increased more than Rs 1,000 crores per year. This increase was due partly to the heavy doses of deficit financing injected into the economy in the context of the Five Year Plans and partly to an increase in monetary transactions. The growing pressure of population (2.2 per cent per year in 1951–61 and 2.5 per cent per year in 1961-71), the high rate of annual investment—Rs 3,000 crores in the Fourth Plan, mounting Government expenditure leading to larger money income in the hands of the people, undisputedly, contributed to the rise in prices.

The Fifth Plan should have price stability as its major objective. The persistent pressure of galloping inflation during 1972-73 and 1973-74 adequately demonstrates that the central banking authorities and the Government were not conscious of their responsibility to maintain price stability. The origin of the

*The wholesale price index increased by 11.9 per cent in 1974-75 and India experienced 'stagflation' or 'slump inflation'.

serious inflationary pressures on the price level experienced in 1972–1974 can be traced to the 'panicky nervousness of the Government'. Erratic movements of prices obviously run counter to the objectives of 'economic growth in an environment of reasonable price stability'. The financial outlays in the Five Year Plans appear to have lost a large part of their leverage effect on general development. There has been a steady deterioration in the rate of growth, and the causes of the 'diminishing returns' from public sector development outlay and their remedies must be investigated thoroughly. The following data illustrate the Plan outlays and the gradual deterioration in the national income in the Fourth Plan period :

Year	*Plan Outlay (Rs in Crores)*	*Growth Rate of NNP*
1969-70	2,209.9	5.5
1970-71	2,523.5	4.3
1971-72	3,130.3	1.7
1972-73	3,973.4	−1.8
1973-74	4,364.2	Not available

VI

Classification of Inflation in Selected Countries

The lengthening image of inflation is a disquieting feature for the central monetary authority; it hangs ominously over the planning effort acting as a fetter on sustained growth. The rate of real income growth has trailed far behind that of monetary expansion with its attendant effect on the price level. In the Third Plan period, against a monetary expansion of 63 per cent, real income growth has been no more than 14 per cent, and in 1965-1966 alone, while monetary expansion amounted to 11 per cent, real output declined by 4 per cent. Even after allowing for the increasing monetary requirements of the economy, this represents a wide gap between money and output and cannot but leave a deleterious effect on the price level and the economy in general. It is enough to state as a broad proposition that, in Indian conditons, if the money supply in the country runs substantially ahead of the increase in the production of goods and services, the price level is bound to rise after an interval of time. If, on the contrary, money supply rises more slowly than the production of goods and services, the price level is likely, after a certain time, to fall.[21] Monetary policy in such a situation has to be restrictive, but due care must be taken that the needs of the *bona fide* trade and priority sectors as well as those of the busy season are met as far as possible. In this respect much depends on the central banking policy and vigilance towards the use and end-use of selective methods of credit control for stimulating genuinely productive sectors.

[21] Speech delivered before the Society for International Development, Madras Branch on November 1, 1960, by H. V. R. Iengar, ex-Governor of the Reserve Bank of India.

It must, however, be noted that India has not followed the path of the Latin American countries, especially of Brazil, Argentina and Chile, which have hyper inflation—above 15 per cent p.a. (Table 5.4). As Grunwald[22] observes: "Inflation became a way of life and was institutionalised into the legal and socio-economic structure of the country, each sector of the economy constructing its own defence apparatus."

TABLE 5.4. Percentage Classification of Inflation in Selected Countries, 1957–1966

Country	*Type of Inflation*	*Annual Average Rate of Increase*			
		Cost of living	*Food prices*	*Money supply*	*National Income*
Brazil	Hyper Inflation (above 15 p.a.)	46.9	46.5	49.0	5.4
Argentina	do	35.3	36.7	28.0	3.7
Chile	do	25.1	28.1	25.5	4.1
Colombia	High Inflation (7-15)	12.3	12.7	16.3	4.4
Peru	do	9.2	10.5	13.2	5.7
India	Moderate Inflation (4-7)	6.1	6.2	7.8	3.3
Ghana	do	6.1	7.6	11.8	3.5
Israel	do	5.7	4.2	14.8	9.6
France	do	5.1	4.9	11.3	4.2
Japan	do (2.5)	4.4	3.6	16.2	9.8
Philippines	do	4.2	4.6	9.0	4.0
Iran	do	3.6	4.1	15.2	6.5
Italy	do	3.4	2.7	13.1	5.2
UK	do	3.1	2.2	3.8	3.2
West Germany	Stable (upto 2.5)	2.4	2.4	8.0	5.4
Australia	do	2.1	2.1	2.6	4.6
Canada	do	2.1	1.9	7.3	3.8
Ecuador	do	2.4	3.5	8.4	4.5
USA	do	1.9	1.8	2.5	3.8
Thailand	do	1.7	2.2	9.1	6.3
Ceylon	do	1.2	0.5	5.6	3.1

Note: 10-year average for Money Supply, Cost of Living, Consumer Price.
* Based on average rate of increase in cost of living indices from 1956 to 1966.
Source: *International Financial Statistics*, January 1964 and January 1968.

Though India did not suffer from high inflation of 7-15 per cent p.a. which was registered in Columbia and Peru, it topped the list of the countries experiencing moderate inflation which is 4–7 per cent. As an emerging country, India did well in comparison with the Latin American countries; but she failed, however, to accomplish the delicate balance between the aims of growth as well as stability.

[22] Grunwald, Joseph, "The Structuralist" School on Price Stabilisation and Development—(pp. 95–124), edited by Hirschman Twentieth Century Fund, New York, 1961.

We wish to emphasise the fact that there is no simple and self-evident causal nexus between growth on the one hand, and inflation on the other, in either direction. A careful analysis has been made of various Tables drawn up by the Bank for International Settlements comparing the average annual growth rates in a number of countries with the average annual increase in prices in the same countries, from 1900 to 1963. In the first group of countries—Norway, Sweden, the Netherlands and the USA—the average annual growth rate, calculated on the basis of constant prices, is comparatively high and in most cases greater than the rise in the general price level. For Norway the growth rate is 3 per cent, while the rise in prices also works out at 3 per cent. For Sweden the figures are 3.1 and 2.8 per cent respectively; for the Netherlands 2.7 and 2.5 per cent; and for the USA 3 and 2.4 per cent.

In the second group of countries, comprising Italy and France—which suffered particularly from the consequences of the two World Wars—the average annual growth rate during the same period is smaller, and distinctly lower than the average annual rise in prices, which is very marked. For Italy the growth rate is only 2.4 per cent, compared with a price rise of 10 per cent. In the case of France, the growth rate is also 2.4 per cent, while the price rise works out at 9.5 per cent. Finally, in the United Kingdom the growth rate is also noticeably lower than the price rise. The former comes to 1.9 while the latter is 2.3 per cent.

An underdeveloped country that attempts to change and grow rapidly faces certain tensions which may result in inflation. Whether this happens or not depends on the following factors: the pace at which economic change occurs; whether external developments are favourable or not; the flexibility of internal economy (reflecting not only the productive structure but also a wide range of institutional, social and cultural characteristics); and the extent to which the policies followed by the Governments ease or aggravate the process of transformation.[23]

VII

Observations

Thus, it is evident that inflationary pressures were generated in the Indian economy towards the end of the First Five Year Plan. This pressure, which was intensified during the Second Plan, continued unabated throughout the Third Plan. It is admitted even by the Government that the value of the rupee has dwindled to almost one fourth (27 paise) at the end of the Fourth Plan on the basis of the 1960-61 price index and threatened the whole concept of real growth of the economy through planning. The Reserve Bank generally followed throughout a policy aimed at channeling the flow of funds into the desired sectors of the society without necessarily curtailing the total quantum of credit. The Reserve Bank was only partly successful in its attempts, which under the

[23] "Inflation & Growth: A Summary of Experience in Latin America", *Economic Bulletin of Latin America*, UN Economic Commission for Latin America; February 1962, pp. 21-26.

circumstances might be considered satisfactory. For, on the one hand, the cause of the inflation that threatened to undermine the gains of development could be traced to nonmonetary factors such as low agricultural production, etc. over which the Reserve Bank had little control. On the other hand it is openly admitted that monetary policy, because of its limitations in an undeveloped economy like India in which fiscal policy dominates the economic scene, can at best be only a partial success in the overall objective of the attainment of growth within an environment of reasonable stability.

In a developing economy not only a steady but a rising rate of growth is desirable. The two major constraints on growth in India have been the shortage of savings in relation to investment needs and the inadequacy of foreign exchange. Clearly, in order to promote growth it is necessary to make heavy investments but the shortage of savings still exists. In the resultant situation there is both the pressure and the temptation to expand investment through deficit financing or credit creation. Either of these, unless their volume and timing are carefully determined, will lead to excessive monetary expansion and an upsurge in prices. Therefore, the danger of an inflationary price rise remains a constant threat in the process of development.

There is another factor somewhat peculiar to Indian conditions which has a bearing on the problem of inflation and the safe limits of monetary expansion. That is the key role of food supplies. The increase in income resulting from a step-up in investment generates a marked increase in the demand for food, particularly as the population also is increasing. Food items have a high weightage in any index of consumer prices. The inadequacy of food supplies in relation to rising demand leads to an increase in food prices which is soon transmitted, both directly and through wages, into the cost structure. A demand-generated inflation of food prices thus tends to become a cost-induced inflation of industrial prices. In Indian conditions food supplies are major factors to be taken into account in determining the safe limits of monetary expansion. The bulge in the food prices especially in the developing economies[24] during the period 1956 - 66 was due to the failure on the farm front caused either by the overemphasis on industrialisation, or by the neglect of the agricultural development. It may be added that harvest fluctuations as a prime factor conditioning or limiting the pace and rhythm of development is not peculiar to India but characterise all developing economies in which agriculture looms large.

With the increase in social responsibilities in the modern state, the most difficult pressure for the monetary authorities to resist are those that come from the public sector. It is well-known that at the stage of development that Professor W. W. Rostow calls "preconditions to take off", investment of overhead capital is required which, because of its very nature, can only be carried out by the Government. Such is the case with large irrigation projects, railroads, highways, port facilities, potable water, sewage and other urban facilities. In most underdeveloped countries it also includes electric power, telecommunications, hospitals, schools, markets, and low-cost housing.

[24] For example, Brazil 46.6, Argentina 36.7, Chile 28.1 and India 6.2 per cent.

If we proceed to analyse the economic mechanism and the historical facts, it appears immediately that monetary stability is one of the essential conditions for rapid and lasting growth because it is the most powerful force behind the formation of savings, without which it is impossible to carry out the investments that are indispensable for such growth. Monetary stability is also essential to win the confidence of foreign capital which, if the yield prospects are good, can be expected to supplement the supply of domestic savings available to finance the country's investment needs. Monetary stability is likewise necessary to en courage a rapid increase in productivity, which is also fundamental to economic growth. This is strikingly confirmed by the experience of the past twenty years, which brings out particularly forcefully the influence of monetary stability on development and growth. In Europe, since the end of the War, as soon as each country decided to take the necessary measures in the credit field to reestablish the stability of its currency and to defend it within a liberal framework, many problems which had previously seemed insoluble were quickly resolved and the country once more enjoyed considerable prosperity. This was the case in Belgium 1946 onwards, in Italy since 1947, in Germany after 1948, in the Netherlands after 1949, Austria after 1951, in the UK after 1957, France after 1958 and Spain after 1960.

To ensure a better defence against the various possibilities of inflation, it seems essential that the monetary authority should enjoy a large measure of independence *vis-a-vis* the political authority in spite of the wish that some people may have to subordinate the former to the latter (see Chapter 14). The independence of the monetary authority from the political authority is not enough in itself, however, to ensure a really effective defence against inflation. It is essential that this independence be supplemented by legal provisions giving those responsible for monetary policy a secure foundation which will enable them to resist effectively any pressure that the Government may be tempted to exert on them.

In many countries experiencing social and political problems, it is generally insufficiently realised that these often have their roots in the continual depreciation of the currency, the consequent rise in prices and the resulting insecurity. The constant rise in prices is a source of anxiety to the families of wage and salary-earners, whose incomes never keep up with prices and who see before them the wealth and luxury of those who take advantage of the fall in the value of money, reap easy profits and make huge fortunes. It is, thus, not surprising that countries in a state of monetary instability are generally a prey to disorder, revolutions or civil war—the precursors of a repressive system of Government. It may certainly happen sometimes that monetary disturbances originate from political difficulties, but it is much more common for profound monetary disturbances to lead, in a very short time, to political unrest.

In conclusion, it seems to emerge clearly both from abstract analysis and from observation of economic and monetary phenomena that in economic and social life the two essential objectives can be pursued concurrently in order to achieve an expansion of production and an improvement in the standard of living, political and economic freedom and monetary and price stability. These objectives by no means conflict with one another but are, on the contrary,

complementary. Per Jacobsson[25] expressed it admirably:

> It seems to be a lesson of history that without stable money neither justice nor progress can be assured, and that the human spirit cannot give of its best if it is harassed by all the uncertainties to which rapidly changing money values give rise....

Modern money depends on credit—and credit cannot be separated from confidence. Questions of monetary technique play a role—even a great role—but above them stand the moral requirements of a sufficient determination and will to cooperate nationally and internationally "so that proper solutions can be found to the many problems which arise in the management of the monetary system".[26]

[25] *The Per Jacobsson Foundation Lecture,* "Economic Growth and Monetary Stability", Basle, Switzerland, 1964.

[26] Quoted by Mr. Maurice Frere, Honorary Governor, National Bank of Belgium, at the *Per Jacobsson Foundation Lecture* on November 9, 1964.

PART TWO
Economic Role: Promotional and Developmental

6

The Role of the Reserve Bank of India in the Realm of Agricultural Credit

The Central Bank as an Engine of Growth : Its Promotional and Developmental Role in Financing the Agricultural Sector

A central bank in an underdeveloped economy has been regarded as an engine of growth. It has a twin role to perform in such a country, that of a regulator as well as that of a promoter. In the circumstances, the promotional or developmental aspect of the central bank's role has come to be considered more significant than that of the regulatory aspect in an underdeveloped economy. But there is no inherent contradiction between the two roles. In fact the two may be coordinted with each other, or one may even be superimposed upon the other.

Besides the enlargement of the scope of monetary policy during the planned development period, the Reserve Bank of India was also confronted with the very important task of initiating the deliberate promotion of development finance. The Planning Commission, too, emphasised that the more positive role of the central bank in a planned economy should be to ensure that finance is made available for developmental activities within the framework of the priorities of planning. The Reserve Bank of India, as the central arch of the banking and monetary framework of the country, emerged with the promotional role of developing the institutional facilities for financing the lagging agricultural sector.

That the financing of agriculture requires some special treatment at the hands of the central bank was not recognised by the Reserve Bank till the formulation of the First Five Year Plan which stressed the development of agriculture. Till the beginning of development planning in 1951, the attempts of the Reserve Bank at agricultural finance were inadequate and indirect. It did have a separate Agricultural Credit Department but its function was primarily one of research rather than the financing of agriculture. The classical concept of the

central bank of a country as the note-issuing authority and as the bankers' bank has given place to a much more comprehensive concept. In the context of the positive role which the Government of India has assumed for bringing about rapid economic development through quinquennial plans, the central bank, as an important State institution, is to take positive steps for the establishment and growth of a sound structure of credit institution to meet the requirements of the different sectors of the economy.

The constitution of the Reserve Bank of India has followed, more or less, the traditional pattern of central banks in Western Europe. There is, however, a significant departure at least in respect of agricultural finance. Under the pressure of Indian public opinion the statute contained a directive to the Reserve Bank to take an active part in the development of agricultural credit and rural cooperative organisations. In fact, few aspects of the working of the Reserve Bank have been so striking, in comparison with other central banks generally, as its role in the realm of rural credit. The importance of rural credit in the Indian economy was recognised long before the idea of planning was developed. As a matter of fact, when the discussion on the establishment of a central Bank for India began, it was emphasised that the financing of agriculture should be given an important place. Sir Basil Blackett, then Finance Member of the Government of India, introducing the first Reserve Bank of India Bill, hoped that it would "do a great deal to advance the interest through the cooperative banks, of agriculture, of the marketing of produce and the facilities for agricultural banks generally".[1]

The Reserve Bank's responsibility in the sphere of agricultural finance has been occasioned by the predominantly agricultural basis of the Indian economy and the urgent need to expand and coordinate the credit facilities available to the agricultural sector. With a view to enable it to fulfil this important role, the Reserve Bank of India Act itself laid down in Section 54 that the Bank should set up a special Agricultural Credit Department, the main functions of which were:

(a) to maintain an expert staff to study all questions of agricultural credit and be available for consultation by the Central Government, State cooperative banks and other banking organisations,

(b) to coordinate the operations of the Reserve Bank in connection with agricultural credit and its relations with State cooperative banks, and any other banks or organisations engaged in the business of agricultural credit,

(c) to finance the movement of crops and other agricultural operations through State cooperative banks and other suitable agencies of rural credit.[2]

The specific mention of agricultural credit as a sphere of special responsibility of the Reserve Bank of India right from the start is significant inasmuch as it shows the awareness on the part of the framers of the Act that the Bank could

[1] *Capital* (Supplement), December 21, 1961, p. 107.

[2] *The Reserve Bank of India, Functions and Working*, Bombay, p. 70.

not function satisfactorily unless special efforts were made to organise and develop, under its guidance and direction, a system of credit for the country's most important economic sector—agriculture—which had remained virtually outside the purview of modern banking.[2a]

The man behind the plough in India is born in debt, lives in debt and dies in debt. Rural indebtedness[3] is the most alarming problem in the agriculture-dominated subsistence sector of the Indian economy. The salient feature of the rural indebtedness problem in India arises from the activities of the moneylenders who earn mainly by capitalising on the perpetual poverty of the peasants. A well-known, caustic French proverb that "credit supports the farmer as the hangman's rope supports the hanged" describes the situation aptly. The agriculturists take new loans either to pay the interest on old loans or for ready cash for marriages and religious ceremonies. Since the funds are not generally borrowed for productive purposes, it is unlikely that the original amount will ever be paid in full. Typically, in the Indian situation debts signify misery or catastrophe and are never viewed as a means for enhancing productivity and income-earning capacity. During the British regime, the investigations carried out by Sir M. L. Darling showed that in Punjab, where agriculture was considered to be relatively productive, only five per cent of rural indebtedness was contracted for improving land. Due to the heavy load of indebtedness, the agriculturist was unable to introduce methods for improving agricultural production. The volume of indebtedness made him callous, undermined his efficiency and destroyed his initiative for work. The result was low productivity, perpetual indebtedness and ancestral debt. All these worked in a vicious circle and bogged down Indian agriculture in a stagnant pool of apathy, devoid of progress and prosperity.

The Darling Report revealed certain irregularities with regard to cooperative finance. It suggested legislation for the regulation of moneylending with a view to controlling the rate of interest charged by moneylenders, improving their methods of business and expressed the opinion that the cooperative movement was the best agency for the supply of agricultural finance. The Report suggested that the cooperative movement was capable of playing its proper role in supplying credit facilities to the rural sector of the economy provided it was 'reconstructed and revitalised'.

The broad picture of agricultural credit was summed up by the All India Rural Credit Survey (RCS) appointed by the Reserve Bank of India in the following words:

> Today agricultural credit that is supplied falls short of the right quantity, is not of the right type, does not serve the right purpose and by the criterion of need (not overlooking the criterion of creditworthiness) often fails to go to the right people.[4]

[2a] Speech delivered by Mr. J. J. Anjaria, the Deputy Governor, Reserve Bank of India at the Seventh SEANZA Central Banking course held at Colombo, on September 10-11, 1968.

[3] With the promulgation of Emergency in India in June 1975, the Prime Minister has declared a moratorium on rural indebtedness for two years.

[4] *The Reserve Bank of India, Functions and Working*, Bombay, p. 73.

To remedy this alarming state of affairs in the field of agricultural credit the RCS Committee made a number of vital recommendations for building up a strong and integrated system of rural credit. The development of cooperative credit constitutes the cornerstone of the entire edifice of the recommendations of the Committee. The Committee observes that "in the field of rural credit cooperation has failed, but cooperation must succeed".

The foremost objective of policy, as recommended by the RCS Committee, was the positive and deliberate creation of conditions in which cooperative credit would have a reasonable chance of success. The policy of the Reserve Bank in the sphere of rural finance, according to the RCS Committee, should be directed towards achieving this objective as speedily as possible. It is thus evident that the Darling Committee recommendations and the RCS Committee recommendations are similar as regards the role of cooperation in the field of agricultural credit. Cooperation has an important role to play as the most suitable medium for the democratisation of economic planning. The Third Five Year Plan states clearly that

> In a planned economy pledged to the values of socialism and democracy, cooperation should become progressively the principal basis of organisation in many branches of economic life, notably in agriculture and minor irrigation, small industry and processing, marketing, distribution.

The First Plan encouraged different forms of cooperative activity and set targets for the provision of agricultural credit through cooperatives. These targets were enhanced under the Second and Third Five Year Plans.

The existing laws in force at the time made it impossible for the Reserve Bank to lend to agriculturists directly or to advance large sums to cooperative banks or indigenous bankers for reloaning them to cultivators as a matter of course. But an even more significant limitation was that the Reserve Bank could not meet the long-term credit needs of agriculturists. Partly with the objective of relaxing some of the above stringent legal limitations and partly to reconstruct and revitalise the entire cooperative credit movement as preparatory to the larger planning needs of the country, the Reserve Bank recommended the setting up of the Rural Banking Enquiry (RBE) Committee in 1949, convened an Informal Conference in 1951 and appointed the All India Rural Credit Survey Committee. Thus began a new era in the history of the role of the Reserve Bank of India in the realm of rural finance.

II

Legal Reforms to Reconstruct and Revitalise Agricultural Credit

As stated above, the Reserve Bank is not empowered to finance agriculturists directly; accommodation to the cooperative movement is channeled through State cooperative banks. With the commencement of planning in November 1951, the State cooperative banks were placed on the same basis as scheduled banks in regard to the purchase, sale or rediscounting of bills of exchange arising out of *bona fide* commercial or trade transactions. This was done by amending

Section 17(2) of the Reserve Bank Act. The Bank thus provides accommodation to State cooperative banks in the form of *rediscounts* under Section 17(2)(a), (b) and (bb), and *advances* under Section 17(4)(a) against Government and trustee securities including debentures of central land mortgage banks guaranteed by the respective State Governments. Furthermore, the Reserve Bank was empowered, for the first time by the amendment of Section 17(2)(b) to extend loans for a period of 15 months to finance seasonal agricultural opertions and marketing. This section covers in its purview mixed farming activities, as well as processing of crops prior to marketing, by agricultural producers or any organisation of such producers. The Reserve Bank was also given power under Section 17(2)(bb) for rediscounting of promissory notes and bills maturing within 12 months which were drawn or issued for the purpose of financing the production or marketing activities of cottage and small-scale industries approved by the Reserve Bank provided the repayment of the principal and payment of interest of such bills of exchange or promissory notes is fully guaranteed by the State Government. Finally, by the insertion of Section 17(4*AA*) the Bank was empowered to advance medium-term loans to State cooperative banks at 1.5 per cent below the bank rate for periods ranging between 15 months and 5 years, if guaranteed by the respective State Governments. It is interesting to note in this connection that while medium-term credit occupies an insignificant place in the credit structure of other countries including the USA, these loans are of special importance under Indian conditions. In India, they are required for a variety of purposes including reclamation of land, development of irrigation, purchase of livestock, implements, machinery, transport equipment and other allied purposes relating to agriculture. Medium-term loans, therefore, play an important role in the development of the agricultural sector as a whole. Section 17(4)(d) which provides for advances against documents of title to goods has remained inoperative so far, largely because of the absence of licensed warehouses in the country. The short-term credit facilities granted to State cooperative banks under Section 17(4)(c) represents a counterpart of the Bill market Scheme for commercial banks with the difference that, in view of the greater time involved in agricultural operations, refinancing in this sector has inevitably to be for longer periods than in the case of commercial banks.

The above legal reforms provided the Reserve Bank with an opportunity to reconstruct and revitalise the agricultural sector. To ensure that reforms continue on a sound basis the Reserve Bank appointed the Standing Advisory Committee in July 1951, to advise it on "matters pertaining to its Agricultural Credit Department and subjects allied to those matters". It also organised a series of visits by its officials to various states to assist the State Governments in formulating schemes for reorganising the cooperative movement on a sound basis. In addition, it voluntarily undertook the inspection of cooperative banks. Finally, the former practice of fixing credit limits for total borrowings was replaced by a new procedure which provided for the fixing of credit limits in respect of the total amount outstanding on any given date.

The process of reforms and reorganisation in the area of rural finance continued as the country carried out its First Plan. As the Plan came to an end and

the formulation of the Second Plan began, the RCS Committee published its monumental report making a series of pertinent recommendations.

III

The State Bank of India and Agricultural Credit

As a first step in implementing the recommendations of the RCS Committee, the Government established the State Bank of India in July 1955, which took over the former Imperial Bank of India, the largest scheduled bank in the country. In spite of the past record of failure of the cooperatives, the Committee recommended the implementation of an "Integrated Credit Scheme" with cooperatives as the pivot and State-help as the basic precondition. The Committee suggested that the Imperial Bank of India with its peculiar position, unique status and semi-public character be transformed into the State Bank of India with an eye to the creation of a large number of branches in the rural areas so that cooperative banks and societies could get cheaper and quicker remittance facilities and a substantial portion of rural savings could be mobilised. The Committee recommended, *inter alia*, the setting up of a State Bank of India as a strong, integrated, state-partnered commercial banking institution with an effective machinery of branches spread over the whole country for stimulating banking development by providing vastly extended remittance facilities for cooperative and other banks, which would follow a policy in consonance with the national policies. In faithful compliance with this recommendation, the State Bank of India was set up. The statutory target of opening 400 additional branches over the first period of five years was fulfilled before time on July 1, 1960.

A new chapter in the evolution of Indian banking has been opened up with the establishment of the State Bank of India. With mutual understanding, a common sense of purpose and coordination of action between the Government of India, the Reserve Bank and the State Bank, the last complementing the functions of the Reserve Bank in the sphere of agricultural finance, the State Bank of India will emerge as a powerful tool of public policy, including that of a planned development, while at the same time maintaining the highest standard of commercial banking. The nationalisation of the Imperial Bank for the purpose of establishing the State Bank of India marks a big stride forward in the realm of Government-controlled banking in India for fulfilling the requirements of the policy of balanced growth simultaneously in the urban and rural sectors of our growing economy during the process of developmental planning. At present, with a network of offices of its own and those of its subsidiaries, the State Bank of India is effectively catering to the varied banking needs in the rural area and is destined to play an increasingly important part in the economic development of the country. It extends larger remittance facilities in the rural areas than the Imperial Bank used to do and endeavours to mobilise rural savings through its newly opened branches. But it should be remembered that the financial assistance which the State Bank of India is rendering to the

agricultural sector is indirect, being routed through cooperative societies, and is confined mostly to the marketing and processing of agricultural produce. It also plays an important role in popularising the warehousing scheme by granting advances against warehouse receipts.

The State Bank of India is the biggest commercial bank which serves the smallest man. At the end of September 1974, 86 per cent of the farmers financed by the State Bank had landholdings of 4 hectares or less and 68 per cent had holdings of 2 hectares or less. The State Bank Group accounts for more than 87 per cent of all commercial bank loans to the cooperative sector. Free remittance facilities for the amount of Rs 800 crores are provided each year to cover the day-to-day operations of cooperatives and ensure their growth. Assistance is now provided to almost all types of cooperatives including cooperative sugar factories, land mortgage banks, industrial cooperatives, and wholesale consumer stores. In fact, more than one-tenth of the Group's total advances goes to cooperative institutions.

IV

Long-term Operations Fund and Stabilisation Fund as the Pillars of the Reoriented Programme of Rural Credit

After the State Bank of India had been established, the Reserve Bank of India diverted its attention almost immediately to the reorganisation of other aspects of rural credit. For instance, in 1955 the Reserve Bank of India Act was amended. The Act, *inter alia*, established the National Agricultural Credit (Long-term operations) Fund and the National Agricultural Credit (Stabilisation) Fund under Section 46(A) and 46(B). The RCS Committee proposed the establishment of two Special Funds under the Reserve Bank of India and one Special Fund under the Ministry of Food and Agriculture:

(i) The National Agricultural Credit (Long-term Operations) Fund: This Fund would enable the Reserve Bank of India to give long-term loans to the State Governments participating in the share capital of cooperative banks, mortgage banks and credit societies; this fund may also be used by the Reserve Bank for granting long-term accommodation—for periods exceeding five years—to land mortgage banks;

(ii) The National Agricultural Credit (Stabilisation) Fund: A sum of Rs 1 crore annually would be credited to this Fund to be utilised for the purpose of granting medium-term loans to State Cooperative banks, specially if on account of famine, drought, etc., they are unable to repay their short-term loans to the Reserve Bank;

(iii) The National Agricultural Credit (Relief and Guarantee) Fund: Another sum of Rs 1 crore annually would be credited to this Fund which will be under the Ministry of Food and Agriculture and will be utilised for giving grants to cooperative credit institutions through the State Governments concerned, for the purpose of writing off irrecoverable arrears specially after chronic and widespread famines.

These Funds serve as the main pillars on which rests the reoriented programme of rural finance to be operated on cooperative lines. They also impart a substantial amount of stability to the structure of rural finance specially during periods of emergency.

The Committee also hoped that in view of the necessity for the implementation of a reoriented scheme of rural finance it would be useful to train a new type of personnel who are not only technically qualified but also have a rural bias in their sympathies and attitudes.

During the process of developmental planning for the uplift of the lagging agricultural sector and for the expansion of the industrial sector it is but essential that agriculture is placed on a strong footing. A reorganised and reoriented system of agriculture should provide the main sustenance for rapid industrial growth. The aim of the reorganisation of rural finance, therefore, should not only be the provision of easier credit facilities to make the former economically better off but also the mobilisation of savings accruing from his improved economic position. However, it is doubtful whether the cooperative banks and the rural branches of the State Bank of India and other public sector banks are reaching the bulk of our marginal and submarginal cultivators. It seems that a system of 'Supervised State Credit' through the agency of the National Extension Service may be a little more useful if we adopt a 'package deal' programme and provide various types of credit facilities simultaneously in a 'package' to the more responsible class of marginal and submarginal peasants. It should be noted that unless the marginal and submarginal cultivators are rescued from the grip of moneylenders, agricultural development planning with rural credit reorganisation as its basis will fail.

The Reserve Bank (Amendment) Act of 1955, which set up the Special Funds, did not cover advances against warehouse receipts. Since it was felt that the warehouse corporations could be used as important instruments for the development of rural finance, the Agricultural Produce (Development and Warehousing) Corporations Act was passed in 1956. Under this Act the Reserve Bank of India was permitted to grant loans and advances to warehouse corporations under Section 17(4*C*) of the Act newly inserted in 1956. Subsequently other concessions were also made by the Reserve Bank in this regard. For instance, in 1959 it exempted the advances by the scheduled banks against warehousing receipts (which had been issued by the State Warehousing Corporations) from the purview of its directives restricting advances against foodgrains.

V

Agricultural Refinance Corporation: A Refinancing Agency

The most recent development in the area of agricultural credit was the setting up of the Agricultural Refinance Corporation (ARC) on July 1, 1963. The Deputy Governor of the Reserve Bank of India in charge of agricultural credit is its Chairman.

A novel feature of the capital arrangment is the provision that to help build

the working capital, the Reserve Bank will keep the dividend accruing on shares held by it with the ARC as interest-free special deposits for a period of 15 years.

In India, before July 1, 1963, no institution outside the cooperative and mortgage banks used to take any interest in agricultural investments. Even the land mortgage banks were only partially interested in financing development and in most cases they were cut off from access to the open market for long-term funds. The Industrial Finance Corporation (IFC) and the Industrial Development Bank of India (IDBI) excluded agriculture from their operations. No joint stock bank, which did term lending, received any support from a refinancing institution if it desired to lend to an agricultural enterprise. Therefore, to strengthen both the cooperative and scheduled banks for the purpose of agricultural investment a central organisation was called for which would have adequate resources of its own and a free access to the Government, to the Reserve Bank of India and to the capital market. In this connection, it is important to remember that the Rural Banking Enquiry Committee had suggested the setting up of a Central Agricultural Credit Corporation for the country as a whole about twenty-five years ago.

The Agricultural Refinance Corporation is primarily a refinancing agency which helps augment resources available for provision of medium-term and long-term credit for the development of agriculture. It does not supplant, but rather supplements, the existing normal arrangements for long and medium-term finance, including the Reserve Bank of India's assistance for these purposes. Apart from its responsibilities as a refinancing agency, the ARC plays an active role in stimulating interest in special agricultural development schemes, advises the institutions eligible for finance and assists them in planning successfully the agricultural development programmes. Among other business that the ARC may transact is the guaranteeing of deferred payment in connection with the purchase of capital goods by eligible institutions from outside India. It provides financial assistance mainly by way of refinance to the Central land development banks, State Cooperative Banks and scheduled commercial banks. In the case of the Central land development banks, refinancing may take the shape of subscribing to their special development debentures floated in connection with approved schemes of agricultural development. It needs hardly be mentioned that the ARC provides refinance facilities for only such schemes of agricultural development as are technically feasible and economically sound.

In brief, the ARC was promoted by the Reserve Bank of India for making medium-term and long-term loans to primary lenders, that is, to both cooperative and commercial banks. It assists in the financing of compact projects of agricultural development, such as land reclamation and development of land for better utilisation of irrigation, mechanised farming, animal husbandry, dairy farming, exploitation of subsoil water resources and the like. Of the total issued capital of Rs 5 crores, the Reserve Bank of India holds some 59 per cent and the Government of India has provided an interest-free loan of Rs 5 crores, the repayment of which will commence after 15 years. The consolidated picture of the operations of the Agricultural Refinance Corporation is furnished in Table 6.1.

TABLE 6.1. Operations of the Agricultural Refinance Corporation Fourth Plan Period

(Amount in lakhs of rupees)

Year ended June	*Number of schemes sanctioned*	*Total financial assistance sanctioned*	*ARC's commitment in respect of Col. No. 2*	*Amount utilised%* *
	1	2	3	4
1965-66	36	3,473	2,857	490
The Fourth Plan Period				
1969-70	371	25,951	21,489	5,909
1970-71	458	29,300	24,866	8,971
1971-72	711	40,475	35,079	12,469
1972-73	923	57,523	50,143	21,883
1973-74	1,457	80,690	70,410	31,667

Note: Data relate to the position at the end of each year on a cumulative basis suitably adjusted on account of schemes withdrawn or rephased subsequently.

*Figures reported under this column relate to the loans drawn from and debenture subscribed to by the ARC.

Sources: Agricultural Refinance Corporation. *Report on Currency and Finance*, Reserve Bank of India, 1973-74, p. S 81.

The establishment of the ARC has provided an opportunity to State co-operative banks, Central land development banks and scheduled commercial banks to participate in the important task of undertaking agricultural investment for increasing agricultural production. The provision of funds through refinance rather than through direct lending will help the ARC to act in support of other institutions and certainly facilitate agricultural reorganisation and revitalisation which is imperative at the present moment.

Unfortunately, certain irregularities in the implementation of the schemes sanctioned by the ARC have been noticed. In most cases it has been observed that their implementation has not been progressing according to the phasing envisaged therein. The slow progress in the implementation of the schemes is generally due to one or more of the following reasons: (i) unrealistic targets; (ii) delay in release of water from the irrigation projects; (iii) delay in conducting contour surveys; and (iv) delay in the recruitment, training and posting of staff in the various departments of the State Government.

Apart from the slow progress in the implementation of the schemes, our experience in regard to the utilisation of refinance facilities in respect of some of the schemes has also not been satisfactory. One of the irregularities was the introduction of what is generally called a loan deposit system under which the land development bank actually floated debentures for the full amount of loans sanctioned but disbursed only the first instalment of the loan and kept back the amount of the second instalment as a deposit on behalf of the cultivators. The bank had drawn the full amount of the loan by way of refinance from the

ARC without effecting actual disbursements to agriculturists and used a part of the same as interim finance, which was expressly prohibited by the ARC. Under the scheme loans had been given by the primary land development banks to agriculturists much in advance, six months or even twelve months in certain cases, before the reclamation could be taken up by the agriculturists. This resulted in the agriculturists having been given several lakhs of rupees without the money being put to use immediately or within a short time for reclamation purposes. These, and various other irregularities, indicate a very unsatisfactory position regarding the utilisation of refinance obtained by the banks from the ARC. In view of this, the Board of the ARC must advise the bank concerned that it should actually disburse the entire amount of refinance drawn from it and ensure the proper utilisation of the loan by the cultivators for reclamation purposes before floating any further series of debentures. The ARC must caution the financing banks that it will insist on proper utilisation of refinance provided since the schemes approved by it would not bring about an increase in agricultural production unless financial assistance was actually utilised for the purpose for which it was obtained.[5]

The interim recommendations of the All India Rural Credit Review Committee[6] have rightly assigned a promotional role of growing importance to the Agricultural Refinance Corporation not only in providing refinance facilities to cooperative and commercial banks but also in ensuring that in financing investment by the cultivator, technical feasibility and economic viability are looked into and that an increasingly project-oriented approach is adopted so that the services and supplies required for investment are forthcoming. The Committee, therefore, recommends various steps to enable the ARC to equip itself suitably in terms of resources as well as organisation. One recommendation is that it should augment its resources from the National Agricultural Credit (Long-term operations) Fund of the Reserve Bank of India, since one of the important purposes for which the Fund was originally created covers exactly the type of activity in which the ARC is engaged. The Committee also recommends that it should strengthen its organisational machinery in step with the increase in its business. The Committee envisages that in coordination with the Reserve Bank the ARC will help evolve, for the benefit of cooperative and commercial banks, a framework of policies and procedures for financing agricultural development on sound lines. It has also been suggested that steps should be taken for extending, with the prior approval of the Government of India and the Reserve Bank, the categories of institutions eligible for the facilities provided by the ARC.

A significant development during the year 1973-74 was the amendment to Section 22(4) of the ARC Act which removes a major statutory constraint in the way of scheduled commercial banks seeking refinance from the ARC. In terms of the above amendment, the Board of Directors of the ARC is vested with the power to waive at its discretion, both Government guarantee and 'other

[5] Speech by the Chairman, Shri M. R. Bhide, at the Third Annual General Meeting of the Shareholders of the Agricultural Refinance Corporation held on September 26, 1966.

[6] *Reserve Bank of India Bulletin* February, 1969, p. 217.

security' in respect of refinance. The banks will, however, continue to obtain security from the ultimate borrowers.

VI

Trends in Cooperative Credit

While concentrating upon the extension of credit facilities for agricultural purposes, the Reserve Bank did not overlook the advantages of mobilising rural savings. In fact, it formulated an extensive and comprehensive scheme in November 1957, according to which the Central land development banks were permitted to issue six or seven year loans for productive purposes. It was felt, however, that these land development banks needed assistance and encouragement in their endeavour. Consequently, the Reserve Bank undertook to subscribe up to two-thirds of a series of rural debentures floated by them. The scheme was subsequently revised to allow them to float debentures in two sets, one for seven years to be offered to the public and the other for a period of fifteen years to be taken up by the Reserve Bank, the contribution of the Bank being slightly more than the subscription from the public, in the proportion of 8:7.

The procedure laid down for short-term accommodation from the Reserve Bank is that each Central cooperative bank applies to it for a credit limit through its State cooperative bank and the Registrar of Cooperative Societies. The credit limit is for the year commencing on July 1 and ending on June 30. The Registrars have been advised to forward such applications with the necessary details at least one month before the commencement of the year for which limit is required. To ensure that the information supplied with the application is uniform and not lacking in any essential details, a form of application has been prescribed. The banks have also to forward, with these applications, particulars of their latest financial position together with the audited belance sheet for the previous three years. Each drawing under a credit limit is allowed a full period of 12 months and in exceptional cases up to 15 months. In West Bengal and Orissa where the Central cooperative banks are not strong enough to obtain accommodation on their own, credit is granted under Section 17(4)(c) to the State cooperative banks against the guarantee of the respective State Governments both as regards repayment of principal and payment of interest, the Reserve Bank relaxing only the overall limit covered by such a guarantee.

The Reserve Bank of India has undertaken to make agricultural finance available to the rural sector on a liberal scale as well as at cheaper rates. By far the most important assistance towards cooperative finance from the Reserve Bank of India is in the nature of short-term finance at a concessional rate of interest, 2 per cent below the bank rates, for seasonal agricultural operations and marketing of crops (Table 6.2). The accommodation is provided to the State cooperative banks and is passed on by the latter to the Central cooperative banks and primary credit societies. The credit limits sanctioned for cooperative institutions are linked to their owned funds in the shape of share capital and the reserve fund, and their performance on repayment on due dates, so as to give

them an incentive to function on sound and efficient lines. Normally, "A" class Central cooperative banks are granted credit limits up to thrice their owned funds (paid-up capital plus reserve fund) and in exceptional cases four times this sum; in the case of "B" class Central cooperative banks, it is twice their owned funds and in exceptional cases thrice as much."C" class Central cooperative banks, on the special recommendation of the Registrars, are eligible for credit limits up to twice their owned funds only.

During the period 1960–61 to 1972–73 the borrowings of the State cooperative banks from the Reserve Bank of India for short-term agricultural purposes recorded almost a fourfold increase (e.g. sanctions rose from Rs 112 crores to Rs 431 crores and drawals from Rs 143 crores to Rs 619 crores). The provision of extensive credit facilities to cooperative banks by the Reserve Bank is a significant departure from the orthodox concepts of central banking functions but this function is quite consistent with the central banking role in a predominantly agricultural country. Nevertheless, cooperative banks should rely increasingly on their internal resources leaving the Reserve Bank to its role as the lender of the last, and not the first, resort. A scheme of disincentives for borrowing from the Reserve Bank has already been introduced. Under the scheme, a concessional rate of interest is linked with the efforts made by the Central cooperative banks at deposit mobilisation.

The financial accommodation provided by the Reserve Bank of India to cooperatives in the Fourth Plan is presented in Table 6.2.

The achievements of the cooperative reorganisation programme undertaken with the assistance of the Reserve Bank are reflected in the overall coverage of the cooperative system. It is estimated that cooperative credit, which was only 3 per cent of the total rural credit in 1951–52 when India launched her First Five Year Plan, is at present around 25 per cent of the total.

The problem, however, cannot be regarded as solved yet as there are serious gaps still to be closed. Efforts to strengthen the cooperative credit structure to mobilise rural savings and to disburse credit on a production-oriented basis are continuing. The Reserve Bank has now substantial regulatory powers *vis-a-vis* the cooperative credit structure. It has been actively assisting in the provision of training facilities necessary for the managerial and supervisory personnel. The object is to improve steadily the operational efficiency of the system and to make it progressively more self-reliant.

The object of making the cooperative banks more self-reliant stems not only from the cooperative philosophy but also from the principle that central bank has the absolute responsibility to regulate the currency and credit situation and must avoid any action which may lead to an inflationary situation.

VII

Inadequacy of the Cooperatives in Fulfilling Their Assigned Task

Ever since the beginning of the planning era, the State-partnered cooperative credit structure has been used as the main instrument of agricultural finance

TABLE 6.2. Reserve Bank of India and Cooperative Credit 1969-70—1973-74 Fourth Plan Period

(In lakhs of rupees)

Short-term Loans to State Cooperative Banks

Year	Seasonal agricultural operations (a)		Marketing of crops including cotton and kapas (a)		Purchase and distribution of chemical fertilisers (b)		Nonagricultural purposes: Handloom weavers' societies: Purchase of yarn (c)		Handloom weavers' societies: Production and marketing activities (d)		Other groups of industries towards their production and marketing activities (c)		General banking purposes (c)		Cooperative sugar factories against stocks of sugar (e)	
	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1960-61	13,166	7,914	—	—	—	—	42	12	240	241	—	—	319	9	—	—
1965-66	24,937	14,472	—	—	—	—	311	39	555	557	—	—	3,723	—	—	—
Fourth Plan Period																
1969-70	41,667	23,482	710	490	3,752	959	11	6	949	642	—	—	2,130	33	—	—
1970-71	41,320	26,538	779	344	1,127	172	4	3	1,236	783	2	2	2,024	—	—	—
1971-72	48,267	25,106	1,279	734	2,304	236	14	—	1,491	952	59	33	1,413	58	792	—
1972-73	54,984	23,728	9,538*	1,220*	750	—	8	3	913	773	30	11	1,281	—	—	—
1973-74	60,329	20,781	4,529*	1,117*	—	—	30	—	1,339	503	47	28	1,028	30	—	—

TABLE 6.2. *(Contd.)*

(In lakhs of rupees)

National Agricultural Credit (Long-term Operations) Fund

Year	Conversion of Short-term into medium-term loans to State cooperative banks				Medium-term loans to State Cooperative banks for				Long-term loans to State Governments for contribution to the share capital of cooperative credit societies		Rural debentures of land development banks		Ordinary debentures of land development banks **	
	Against the pledge of Government and other trustees securities representing investment of Stabilisation Funds of banks (c)		Out of National Agricultural Credit (stabilization) Fund (d)		Agricultural purposes (d)		Purchase of shares in cooperative sugar factories/processing societies (c)		(g)		(f)		(h)	
	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings	Amount drawn	Outstandings	Purchase	Outstandings	Purchase	Outstandings
	17	18	19	20	21	22	23	24	25	26	27	28	29	30
1960-61	—	—	—	—	468	763	—	—	275	1,995	33	107	3	67
1965-66	—	—	—	—	706	1,165	—	—	253	2,941	129	548	450	1,545
1969-70	152	19	443	521	952	1,410	—	8	680	3,383	94	950	420	2,784
Fourth Plan Period														
1970-71	253	170	365(i)	435(i)	1,483	1,948	37	43	1,249	4,193	18	959	419	2,192
1971-72	754	705	2,602	2,145	1,415	2,291	25	68	1,414	5,134	133	1,064	441	3,626
1972-73	648	905	2,075	2,845	832	2,134	79	120	1,869	6,555	83(j)	1,125	276(k)	3,261
1973-74	1,089	1,205	9,245†	5,280†	602	1,700	40	117	802	6,800	20	1,128	109	2,927

Notes: Outstandings are as at the end of the period under various Sections of the Reserve Bank of India Act, 1934.

(a) At 2 per cent below bank rate upto 1972-73 and from 1973-74 at 0.5 per cent below bank rate subject to rebate of 1.5 per cent as per the Rebate Scheme excepting under Section 17(4) (a) of the Reserve Bank of India Act which continues to be at 2 per cent below the bank rate. (b) At bank rate upto 1971, or at 2 per cent above bank rate upto 1973 and further raised to 3 per cent above bank rate from 1974. (c) At Bank Rate. (d) At 1.5 per cent below Bank Rate. (e) At 2 per cent above Bank Rate. (f) Include special development debentures from 1962-63. (g) Rate of interest charged to State Governments is 'nil' per cent for the first two years, 2 per cent during the next 3 years, 2.5 per cent for the next 4 years and 3 per cent during the next 3 years. (h) Figures relate to book value of debentures. (i) Include Rephasement Account of Rs 57 lakhs. (j) Rs 45 lakhs at 5.25 per cent and Rs. 38 lakhs at 5 per cent. (k) Rs 124 lakhs at 5.75 per cent and Rs 152 lakhs at 6 per cent.

* Inclusive of amount in respect of limit sanctioned at Bank Rate for monopoly procurement of cotton and kapas.

† Inclusive of amount sanctioned from General Funds.

** Out of General Funds of the Bank.

Source: *Report on Currency and Finance*, Reserve Bank of India, 1973-74, p. S 48.

and the Reserve Bank of India's resources are being used increasingly to buttress the resources of these credit institutions. However, they have not yet been able to achieve the planned target of agricultural credit.

According to the findings of the All India Rural Debt and Investment Survey, 1961-62 made by the Reserve Bank of India, out of the total cash loans of Rs 2,380 crores as on June 30, 1962, outstanding against the cultivators, the share of cooperatives was only 15.5[7] per cent while agricultural moneylenders and professional moneylenders accounted for 62 per cent. It is thus quite obvious that the cooperative credit structure, although patronised and financially backed by the Reserve Bank of India, has not done much to change the complexion of farm financing. Now, the fact that the commercial banks have been asked to supplement the efforts of the cooperatives indirectly confirms the conclusion that the Government has accepted the inadequacy of the cooperatives in fulfilling their assigned tasks. While the nature of service rendered by both sets of banks is the same, the area and the people covered by them and the manner of their operation are essentiality different. Whereas a commercial bank operates on the principle of individual merit and responsibility of a client, a cooperative bank, like all other cooperative institutions, is a collective service offered for a collective need. In a cooperative bank all users of banking service are members of the society. They are both lenders and borrowers. In their capacity as members they participate in decision making without reference to the resources that they bring to the bank, or to the service they obtain from it. In the assessment of credit in a cooperative bank, the need factor is judged for the individual as a part of a group.

A more purposeful advent of commercial banks into rural areas is bound to bring them into a closer relationship with cooperative institutions. It will be helpful to both to have a fair understanding of the approach of each to what is, essentially, one and the same type of function.

As yet not more than 6 per cent of the total bank credit has gone to the rural areas. If a viable rural credit structure is to be created, the restructuring of the cooperatives is necessary. Managerial faults, ineffective postcredit supervision and loan recovery are the factors that mainly contributed to the present unsatisfactory situation. The proposed rural banks will now supplement the existing arrangements instead of supplanting them and are expected to bring about a silent revolution in rural India through credit structure.

VIII

Increased Dependence of the Cooperatives on the Reserve Bank Funds: Its Pros and Cons

Some broad conclusions emerge from the above discussion. Firstly, the cooperative movement in India leans too heavily on the patronage of the

[7] In 1971-72 cooperatives are estimated to have catered to about one third of the agricultural credit requirements.

Government. Nearly 80 per cent of its resources are obtained by way of loans or share capital from Government agencies like the Reserve Bank of India. This is against the basic concept of cooperation which desires progress through self-help. Secondly, the movement can be self-sufficient at least to a considerable extent, if not wholly, if it concentrates on mobilisation of savings in the rural areas, where the annual growth of deposits at 4 per cent is much less than that of the commercial banks at 11 per cent. Thirdly, the cooperative institutions should run their business strictly on commercial principles. In particular, they must watch their growing expenses of management which must never be out of tune with the expansion of the business. They should, and must, reexamine each item of expenditure and observe strict economy. Fourthly, the rate at which overdues are increasing is alarming. Firmness in recovering these must be shown. As observed by the Maclagan Committee, unless loans are repaid punctually, cooperation is both financially and educationally an illusion. The cooperative institutions should remember that slackness in the recovery of loans benefits none, but harms all concerned. Their resources are limited; and unrecovered loans further reduce their ability to grant fresh loans and they are forced to refuse loans even to progressive farmers. On the other hand, farmers from whom loans are not recovered in time, become extravagant and lethargic. Finally, it is necessary to merge weak societies with better-placed ones to create confidence in the minds of the people about the soundness of the cooperative movement.

Lately, the financial assistance rendered by the Reserve Bank of India to cooperatives has been a subject of severe criticism in some quarters. The criticism has gathered momentum in the context of the present inflationary forces haunting the economy. It is feared that the funds which the Reserve Bank supplies to the cooperatives at concessional rates may lead to inflation as the borrowers of these funds may not use them productively, or they may use them in consumption or in hoarding stocks of foods. Further, concessional finance to a particular sector may lead to serious imbalances in the economy. It is also argued that the open-handed policy of the Reserve Bank of India in financing the cooperatives has made the latter indifferent to the task of mobilising resources.

Though the dependence of the cooperative banking system on the Reserve Bank has been progressively increasing, it has not been uniform in the different regions in the country. The dependence is more in the case of two types of regions: those which have a developed cooperative banking system with a wide network of primary societies; and those where the cooperative system has made very little progress.

In the first category of regions, the cooperative movement has undertaken expansion programmes on a large scale due to the availability of resources and guidance from the Reserve Bank of India. These regions have high potential for absorbing such funds, the risk involved is compartively low and on the whole cooperative institutions function in an efficient manner.

The structure in the second category of regions is still in its infancy and weak; generally, the cooperatives work in an uneconomic manner in these regions.

In the former category the Reserve Bank of India funds aid the process of expansion, in the latter they help in setting up a proper cooperative framework on which future expansion can be built. Ultimately, the expansion should progressively lead to the self-reliance of the cooperative banking system. The Reserve Bank should lay down definite criteria with regard to reducing the dependence. Once a bank outgrows the stage of 'infancy' or 'inability', the Reserve Bank should apply such measures as to discourage further borrowing from it. For example, the concessional rate of interest could be withdrawn. The different stages of this process could be so devised that it may automatically lead to self-reliance over a period of time. This kind of programme is necessary for obvious reasons. The latter type of regions comprise a much greater part of the country and when they enter the stage of expansion, the demand for funds will be so great that the Reserve Bank of India may have difficulty in meeting all the requirements of all the regions simultaneously. But if the dependence of the regions most developed in cooperative banking could be reduced, the Reserve Bank of India would find it easier to meet the demand for credit from the latter type of regions. It is, therefore, imperative that a systematic programme of progressive reduction in the dependence of both regions, and within regions the dependence of individual banks should be formulated.

In order to be self-sufficient the cooperative banks have to mobilise savings from the community. The resources required for financing current and capital investment in the countryside will have to be found in a good measure from urban savings for some time to come, and it would not be realistic to expect such a flow of urban resources to take place through private investment activity. The transfer of funds to rural areas has, therefore, to be effected mainly through cooperative banks. The deposit-raising role of cooperative banks is thus becoming increasingly important in the context of the development of the cooperative sector as a whole. The role of the Reserve Bank was vital to the cooperative movement as the cooperatives could not possibly meet their requirements of funds from their own resources only at this stage. In order to augment the supply of credit from the Reserve Bank, the liberalisation of the existing standards adopted by the Bank for sanctioning short-term as well as medium-term credit limits to cooperative banks is suggested. An inference that can be drawn from the expanding activities of cooperative banks is that unless deposits register a greater accelerated growth in future, these banks will have an increased dependence on the Reserve Bank of India funds in order to maintain the growth in advances. The aggregate deposits of 25 State cooperative banks maintaining accounts with the Reserve Bank of India were only Rs 225 crores while borrowings from the Reserve Bank were as much as Rs 312 crores as on the last Friday of 1973-74.

It follows from the above discussion that an ideal policy for these institutions in the future would be to strengthen their resources in the form of owned funds and deposits rather than depend heavily on Reserve Bank funds. Considering the large demand for cooperative credit in the context of the cooperative development scheme envisaged in the Five Year Plans, together with the fact that these institutions will be called upon to bear an increasing burden of the demand for credit in the future, it is important that they continue to strengthen their

position. It is quite obvious that as the economy grows the cooperative banks must become increasingly self-reliant and ultimately reach a stage when they can be of assistance to the nonrural economy by investment of surplus funds. This is the development which has taken place in the Western countries and in Japan. But under Indian conditions, it is so far only a dream for the future. The ultimate guarantee for ensuring that the central bank's contribution to cooperative credit does not prove to be inflationary lies in the progress which is made in strengthening cooperative credit institutions and in the fulfilment of the other allied aspects of the 'integrated scheme'.

IX

The Reserve Bank of India's Statutory Control over the Cooperative Banking Structure

The Reserve Bank of India has assumed statutory control over the cooperative banks after the passing of the Banking Laws (Application to Cooperative Societies Act) 1965. The principal object of the Reserve Bank of India's statutory control over the cooperative banks was to bring about an overall orderly growth and development of the banking sector. With the increase in size and the variety of their operations, both in respect of raising deposits and making loans, the cooperative banks assumed an unmistakable relevance to the Reserve Bank's responsibility for monetary management and credit control. Cooperative banks could now be treated as an integral part of the banking system of the country. The general approach was not to make the Banking Companies Act bodily applicable to the cooperative banks but to apply its provisions on a selective basis so that cooperative banks might be helped to play their expanding role with greater efficiency and success. The Banking Laws (Application to Cooperative Societies Act) 1965, envisaged amendments to the Reserve Bank of India Act, 1934, and the Banking Companies Act, 1949, which has been renamed the Banking Regulation Act. This Act envisaged the scheduling of the State cooperative banks in terms of the relevant provisions of the Reserve Bank of India Act and the licensing of the State and Central cooperative banks and the primary cooperative banks with paid-up capital and reserves of Rs 1 lakh and above. All cooperative banks in existence must apply for licence within three months of the commencement of the Act. Those organised later will have to obtain a licence before they are allowed to function as banking institutions. The Reserve Bank has also the power to cancel the licence issued to any cooperative bank if its affairs are mismanaged and are detrimental to the depositors and creditors. The 14 scheduled cooperative banks are required to maintain a minimum balance equal to 3 per cent of their demand and time liabilities with the Reserve Bank of India, central cooperative banks with the State cooperative banks, and primary cooperative banks with the central cooperative banks. The new Act also requires that the cooperative banks must maintain a total liquidity at 20 per cent of their demand and time liabilities in the form of cash, gold and unencumbered approved securities valued at a price not exceeding

the market price. It is provided that this percentge will be raised to 25 per cent in addition to the minimum cash reserves of 3 per cent two years after the commencement of the Act. The Reserve Bank, at present, adopts a liberal outlook as to the imposition of liquidity restrictions on scheduled State cooperative banks. The statutory liquidity ratio (SLR) and net liquidity ratio (NLR) requirements of the scheduled commercial banks, 33 and 39 per cent respectively, are not applicable to scheduled state cooperative banks. At present a scheduled state cooperative bank has to maintain 28 per cent (25+3) liquidity instead of 37 per cent (33+4) applicable to scheduled commercial banks. Gradually further statutory restrictions are likely to be imposed on their activities. The Act contains provisions for imposing restrictions on intercooperative bank investments. The statute vests in the Reserve Bank the statutory power to conduct inspections of all the cooperative banks through its own machinery and, in the case of primary cooperative banks, through the agency of the State cooperative banks. (For details see Chapter 12.)

X

Observations

A section of society did not relish the entry of the Reserve Bank of India into the cooperative movement in such a big way. The idea of the Reserve Bank of India was only to impart a proper banking bias to the working of the cooperative banks in the country in order to secure a balanced and healthy growth of the institutional system of credit for the cooperative sector and an orderly development of organised banking. The Reserve Bank has given an assurance that the federally integrated character of the cooperative credit structure and the special needs and requirements of the cooperative banks will continue to be borne in mind.

The Agricultural Credit Department of the Reserve Bank, which is familiar with the working of the cooperative banks and the cooperative credit structure, has been entrusted with the responsibility for the administration and enforcement of the new Act insofar as it relates to cooperative banks. The legislation has been reckoned as the recognition of an attainment of maturity by the cooperative banking structure and of the growing importance of cooperative credit in the economic life of the country. Despite the various restrictions envisaged in the new statute, the cooperative banks will continue to enjoy the privileges and concessions in respect of borrowings from the Reserve Bank at 2 per cent below bank rate in case of short-term loans and 1.5 per cent below bank rate in case of medium-term loans.

It must, however, be observed that the present inclination of the cooperative banks to borrow more from the Reserve Bank is based on the fact that such accommodation, carrying as it does a concessional rate of 2 per cent less than the bank rate, is less costly than funds raised in the form of deposits. The Reserve Bank should, in the circumstances, set a target for each Central cooperative bank in respect of the amount by which it should increase its deposits during

each year, on the basis of all the relevant data available and with special consideration for banks which are at a relatively early stage of growth. If this target is reached or exceeded, the bank concerned should be charged a rate of interest which is 0.5 per cent below the concessional rate charged for such finance on its borrowings from the Reserve Bank during the year. On the other hand, if the bank fails to achieve the target and the short-fall is less than 50 per cent, the bank should be charged an additional penalty rate of 0.5 per cent above the concessional rate. If the short-fall is more than 50 per cent, the additional penalty rate should be one per cent.

It is, however, expected that close control and association with the Reserve Bank of India will help in evolving suitable standards in the sphere of cooperative banking which will ensure orderly development and sustained growth. The statutory inspection is bound to bring about considerable improvement in the operational standards of the cooperative banks. Public confidence in the cooperative banks may improve considerably as all the advantage hitherto enjoyed by the scheduled banks will be accessible to cooperative banks as well. The scheduled cooperative banks are expected to attract more deposit funds. In respect of financing rural industries, the State and Central cooperative banks have been included in the list of approved institutions under the credit guarantee scheme of the Reserve Bank of India.

The Mehta Committee has also observed that the Reserve Bank is likely to have to play a prominent part in cooperative financing for many years to come. The magnitude of cooperative financing as envisaged in the Third and the Fourth Plans and the complete implementation of state partnership are likely to enjoin upon the Reserve Bank the responsibility of providing funds to cooperative banks on an even larger scale than in the past few years. But the financial assistance from the Reserve Bank must be viewed in relation to the pace of agricultural development and the total credit requirements of agriculturists in the long run. The financial salvation of agricultural industry lies in finding for it an equally efficient counterpart of the joint stock system of finance which is available to the large-scale organised industries. But in order to make any institutional system of financing a complete success not only the problems of production credit but also processing, warehousing and marketing have to be tackled whole-heartedly and simultaneously. That requires large capital investment, medium, and long-term credit on an increasing scale to place agriculture on as sound a footing as industry. Now the question is whether the cooperative banking structure which is developing fast with the tripartite contribution of the Government, the Reserve Bank of India and the State Bank of India, will ever be in a position to shoulder the entire responsibility, without any outside assistance. Expert opinions on the matter are divergent, but a majority of them hold that even if the cooperative banking system stretches its resources and capacity to the utmost, and even with such assistance as is available from the Reserve Bank of India, it is beyond its capacity to tackle this question to the satisfaction of the requirements of agricultural industry apart from other considerations.

It is, therefore, obvious that the progress of agriculture cannot be tied to the

progress of cooperative credit alone and efforts should not be concentrated solely in the cooperative sector. The cooperatives would be all the better, and the farmer better served too, if other institutions coexisted with the cooperative organisation in healthy competition.[8] Imposition of social control and nationalisation of banks is both a challenge and an opportunity awaiting the commercial banks in the rural sector of the economy. Commercial banks operating in rural areas will find it profitable to extend credit in suitable forms to marketing societies, land development banks and industrial cooperatives. It would be in their own interest, and in the interest of the orderly functioning of the national structure of credit, to deal with cooperative clients, and in perfect understanding with the appropriate cooperative bank which most often will be the apex cooperative bank. In fact, it would be advisable, in the light of past experience and of future expectations, for representatives of the cooperative and the commercial banking systems to meet to evolve generally acceptable norms and procedures of mutual dealing. It is hoped that the good offices of the Reserve Bank of India will prove helpful in this context. Much collaborative and constructive thinking along these lines is urgently called for. It is only through coordination of the various agencies operating in the field of rural credit that the maximum use can be made of the available resources which could be devoted to the needs of agriculture.

The objective of social control and nationalisation of banks would be better realised and the optimum growth rate for the economy achieved if amendments to the Banking Regulation Act conferred on the Reserve Bank new, more positive and purposeful powers to ensure that the fields of assistance by the banks to the agricultural sector include finance for input distribution, crops, plantations, marketing including storage, medium-term capital investment purposes such as pump sets, tractors, etc. and finance for fisheries, dairies, poultry farming and cold storage, etc.

The Reserve Bank has not entered the field of agricultural finance as a perpetual lender, its main object is to build up a self-sustaining system of agricultural finance and then to retire gracefully from the active participation in the movement. The Reserve Bank itself has pointed out that its functions are more to create monetary conditions under which commercial banks, cooperative institutions, and private agencies can operate on sound and economic lines rather than supply credit itself.

The picture of development of cooperative banking which emerges from the above analysis and review of the progress is bright only in parts, dim in a few and quite dark in others. It is impressive in the States of Maharashtra, Gujarat and Madras and poor in the States of Assam, Bihar, Orissa, Rajasthan and West Bengal. The remaining states fall in the intermediate position, where although the results are not unsatisfactory, they leave much scope for improvement.

The growing overdues of the cooperative financial institutions have given

[8] In order to supplement the cooperative sector 50 regional rural banks fused with rural setting and environment are being established.

rise to considerable anxiety. Credit organisations can not function effectively unless their cash flow is regular and their liquidity is maintained. Credit for productive purposes ought to be repaid as soon as production is achieved. The accumulation of overdues also threatens to rob the financial institutions of their refinance facilities. The percentage of overdues to loans outstanding has been increasing alarmingly as is evident from Table 6.3.

TABLE 6.3. Overdues of Cooperatives, 1967-68—1971-72

(Amount in crores of rupees)

	1967-68	*197-172*	*Percentage of overdues to loans outstanding*	
			1967-68	*1971-72*
State Cooperative Banks	18.12	38.34	5.1	6.9
Central Cooperative Banks	135.82	319.36	24.7	35.9
Primary Agricultural Credit Societies	170.98	376.68	32.0	44.0

The causes of overdues are both external—those which are beyond the control of the lending institutions, like the occurrence of natural calamities, irrigation facilities and cropping pattern; and internal—those relating to organisational and supervisory arrangements obtaining within the institution. However, defective lending policies pursued by cooperatives, the general apathy of managements, and also the unfavourable attitude of State Governments have also served as contributory factors. It is our conclusion that without the connivance of the management of the cooperative financial institutions, a sizeable portion of the overdues could not have been accumulated. There should be automatic cessation of the managing committee if the amount of default exceeds 70 per cent of the demand. Certain additional legislative measures are also suggested, for example, the denial of certain rights to defaulting members and compulsory recovery from sale proceeds of produce.

For an effective solution of the agricultural credit problem, it is essential to integrate a crop insurance scheme with the development and extension of cooperative credit societies. Crop insurance initiates an automatic price support programme for agricultural products and acts as a safeguard against fresh debts incurred during periods of crop failure. The Agricultural Credit Department of the Reserve Bank of India in close collaboration with the rural branches of the State Bank of India can easily be entrusted with the task of the administration of a State-sponsored national crop insurance scheme. The local cooperative societies may be requested to assist the rural banks in the work of selling insurance policies on a commission basis. The Agricultural Credit Department of the Reserve Bank should give serious thought to the problem of crop insurance and undertake special research and enquiries on the various facets of the problem and prepare a national crop insurance scheme to be integrated with the rural credit plan.

While there has been a very large expansion in cooperative credit since 1951, the demand out-stripped this expansion. The creation of an Agricultural Credit Board in the Reserve Bank of India is thus thought essential in view of the expanding dimension and complexity of the role of the Reserve Bank in relation to the changing needs of credit for the green revolution. This major structural change is strongly suggested in the present arrangements in the Reserve Bank so as to ensure that the formulation, review and modification of the Reserve Bank's policies in the sphere of rural credit are effectively entrusted to a high-powered group of knowledgeable persons. The various promotional, refinancing, and coordinating functions in the realm of agricultural credit which the Reserve Bank discharges today are appropriately located in the central bank of the country.

The socio-economic significance of enabling persons of modest means to join together to maximise the output of their productive endeavour has special relevance in a democracy which has adopted planning as a method of expediting its economic growth. A well-conducted and progressive cooperative association does good not only to its own members but also to the community. In its special field of monetary management and credit control, these group activities of comparatively small men also help the implementation of the policies of the Reserve Bank. In a democratic way of life, the prevalence of despair and lassitude among the large base of the social pyramid would spell disaster. The special encouragement offered to cooperatives is justified not so much by the claims of individuals who constitute a cooperative, but by the benefit which the community hopes to receive by the satisfactory functioning of cooperative bodies. The development impulse in the country will be greatly strengthened, and indeed quite widely diffused, if the process of development strikes at the root of the agricultural economy and this is just the sort of development that can take the country forward on a new wave of enthusiasm endeavour and achievement.

To conclude, it has been said, that the Indian institution has been continually 'diluting' the essence of central banking by extending the scope of its functions more and more beyond the frontiers of central banking proper.[9] No less an authority than Professor Sayers has given his blessings to the undertaking of commercial banking business by central banks in underdeveloped countries where there are gaps in the financial machinery to be filled. It is his opinion that the central bank should think solely of filling the gaps unfilled by others. If there are no gaps, well and good; it should then stand aside.[10] His argument is thus applicable to an underdeveloped economy like India where the financial and credit system is still immature. In the early stages of a developing economy the central bank has to play a promotional role in broadening and deepening the structure of institutional facilities for the financing of the country's economic development, with itself as the central arch of the banking and monetary framework of the country. In the Indian context, the Reserve Bank of India should not, therefore, abandon its promotional role at this stage and cannot, 'gracefully withdraw' just to concentrate on central banking functions proper.

[9] For details see Chapters 7 and 9.

[10] Sayers, R. S., op. cit., p. 118.

7

The Role of the Reserve Bank of India in the Sphere of Industrial Finance

Aspects of the Problem of Ensuring Adequate Supply of Industrial Finance

The problem of ensuring an adequate supply of industrial finance has many facets. In the first place, the overall volume of investment depends on the volume of savings generated within the economy and the resources that can be obtained from external sources. Part of the domestic savings are generated by industry itself and the extent to which this is done reduces its reliance on savings in the rest of the economy. One aspect of the problem, therefore, is to enable industry to generate as much savings as it can. As to savings in the rest of the economy, the problem is twofold: to increase the total quantum of savings and to develop an institutional structure which specialises in the collection of savings and their profitable investment. The former is a problem of overall economic policy in which monetary policy also plays a key role. The latter is the promotional aspect of central banking policy which has to include, if it is to be comprehensive enough, steps to meet the needs of sectors where initial profitability is low owing either to organisational weaknesses such as in the case of small industry, or owing to rather long gestation periods such as in the case of heavy industries. The promotional role of the monetary policy in India is to improve the efficiency of the banking and other financial institutions, to extend sound credit where needed, and to respond pliantly and promptly to changing conditions. The promotional aspect of central banking policy is thus concerned with locating institutional gaps in the credit structure and making a positive attempt to fill them. We shall concentrate here on the dynamic role of the Reserve Bank of India in establishing new institutions and reorganising the old ones for the deliberate promotion of institutional credit in order to enlarge the industrial sector and also to monetise the economy.

At the time the country embarked on planned development there were serious

gaps in the institutional structure. The commercial banks and the stock exchanges were the two main types of institutions to which the industry had to turn for its financial requirements. The need for rapid industrialisation on the one hand, and the inadequacy of facilities in the domestic capital market on the other, provided the setting for the Reserve Bank's entry in these fields.

Rapid industrial development necessitates an adequate supply of finance for the purposes of fixed and working capital. Indian commercial banks, generally, are unwilling to provide long-term industrial finance on the grounds that they cannot afford to lock up capital and other assets in long-term investments. Investment Trusts and Issue Houses for financing industries are rare in India. Therefore, after Independence, the Government decided to set up special financial institutions for the provision of medium and long-term credit to industrial enterprises. The Reserve Bank played an active part in setting up special agencies to survey term credit. It provided a portion of the capital and borrowing facilities to these institutions and renders them, especially the State Financial Corporations, much assistance in their organisation and working.

II

The Industrial Finance Corporation of India: Planwise Financial Assistance: Its Contribution to the Gross Capital Formation

The Industrial Finance Corporation of India (IFCI) was established on July 1, 1948, with a view to making medium and long-term credit more readily available to public limited companies and cooperative enterprises where normal banking facilities would not be available to them and recourse to the capital market would also be impracticable. The ownership pattern of the IFCI before the establishment of the Industrial Development Bank of India (IDBI) and subsequently is shown in Table 7.1.

The Reserve Bank also subscribed to the bonds issued by the IFCI and agreed to forgo the dividends accruing on its shares in it. This was with a view to

TABLE 7.1. Shareholders of the IFCI

Class of shareholders	*Percentage of shares*	
	As on June 30, 1964	*As on June* 30, 1973
1. Central Government	20.0	—
2. Reserve Bank of India	20.7	—
3. Commercial Banks	24.3	20.0
4. Life Insurance Corporation of India	25.3	22.0
5. Cooperative Banks	9.7	8.0
6. Industrial Development Bank of India	—	50.0
Total	100.0	100.0

strengthening the financial position of the IFCI. Such dividends are required to be credited to a special reserve fund until the aggregate of the sum so credited exceeds Rs 50 lakhs. In addition, an amendment to the Reserve Bank of India Act, 1953, authorises the Reserve Bank to grant loans and advances, both short and medium-term, to it. No maximum has been laid down in the Act on the outstandings of short-term accommodation (repayable within 90 days) granted against Government securities; the medium-term assistance (maturing within 18 months) should not, however, on any date exceed Rs 3 crores.

Over the first twenty-five years the net cumulative assistance sanctioned by the IFCI amounted to Rs 439.82 crores. Table 7.2 presents a detailed picture of the assistance sanctioned and disbursed by it, classified according to the Five Year Plans.

TABLE 7.2. Net Financial Assistance Sanctioned and Disbursed by the IFCI Planwise 1948-73

(In crores of rupees)

Year ended June 30	*Net Financial assistance sanctioned*				*Financial assistance disbursed*			
	Loans	*Under-writings*	*Guaran-tees*	*Total*	*Loans*	*Under-writings*	*Guaran-tees*	*Total*
1	2	3	4	5	6	7	8	9
				Period Prior to the First Plan				
1949	3.25	—	—	3.25	1.33	—	—	1.33
1950	2.90	—	—	2.90	2.08	—	—	2.08
1951	1.98	—	—	1.98	2.38	—	—	2.38
Total	8.13	—	—	8.13	5.79	—	—	5.79
				The First Plan Period				
1952	3.20	—	—	3.20	1.78	—	—	1.78
1953	0.53	—	—	0.53	2.50	—	—	2.50
1954	4.10	—	—	4.10	2.82	—	—	2.82
1955	5.13	—	—	5.13	1.64	—	—	1.64
1956	14.06	—	—	14.06	2.20	—	—	2.20
Total	27.02	—	—	27.02	10.94	—	—	10.94
				The Second Plan Period				
1957	9.15	—	—	9.15	9.78	—	—	9.78
1958	5.93	0.75	1.82	8.50	8.33	—	—	8.33
1959	2.77	0.87	0.27	3.91	7.48	0.66	—	8.14
1960	12.62	0.10	6.06	18.78	8.41	0.17	2.09	10.67
1961	18.58	1.84	8.15	28.57	6.62	0.48	13.02	20.12
Total	49.05	3.56	16.30	68.91	40.62	1.31	15.11	57.04

TABLE 7.2—*Continued*

1	2	3	4	5	6	7	8	9
				The Third Plan Period				
1962	17.84	0.73	0.48	19.05	10.92	0.24	0.41	11.57
1963	19.82	4.63	10.62	35.07	15.05	3.99	3.18	22.22
1964	23.61	4.30	13.16	41.07	16.94	1.96	6.39	25.29
1965	19.39	3.55	3.92	26.86	19.79	3.36	14.65	37.80
1966	21.47	3.96	1.35	26.78	23.99	4.48	2.17	30.64
Total	102.13	17.17	29.53	148.83	86.69	14.03	26.80	127.52
				The Annual Plans				
1967	12.34	1.87	4.00	18.21	29.52	2.90	5.64	38.06
1968	14.90	1.48	0.85	17.23	23.35	1.06	2.61	27.02
1969	22.71	2.42	0.29	25.42	15.03	1.68	0.28	16.99
Total	49.95	5.77	5.14	60.86	67.90	5.64	8.53	82.07
				The Fourth Plan Period				
1970	11.20	1.19	0.13	12.52	16.86	0.85	0.34	18.05
1971	26.51	2.20	0.42	29.13	16.28	0.87	0.20	17.35
1972	33.59	4.68	—	38.27	20.99	1.00	0.11	22.10
1973	43.16	2.34	0.65	46.15	30.00	2.34	0.61	32.95
Total	114.46	10.41	1.20	126.07	84.13	5.06	1.26	90.45
Grand Total	350.74	36.91*	52.17	439.82	296.07	26.04	51.70	373.81

* Includes direct subscription of Rs 3.13 crores.

Note: The figures given in the table do not tally with those given in the Annual Report for previous years on account of cancellations/adjustments subsequently made in the figures for previous years.

Source: The 25th Annual Report of the IFCI.

An analysis of the operations of the IFCI shows that invariably the largest share of the assistance sanctioned by it has gone to Maharashtra, West Bengal and Tamil Nadu—the three most industrialised States in the Union—at the cost of industrially backward regions. In 1963 Maharashtra's share was 17.5 per cent, West Bengal's 10.6 and Tamil Nadu's 16.1 making a total of 44.2 per cent. By 1969-70 the share of Maharashtra shot up to 33.9, of West Bengal to 18.3 and of Tamil Nadu to 15 per cent. There was little change in the regional concentration of assistance although a new policy of special assistance to backward areas has been adopted by the IFCI since 1970. Even in 1973 the picture is not very different from that of 1963. In mid-1973 the share of the three premier States

constituted 44.6 per cent—about the same percentage as in 1963 with Maharashtra's share alone accounting for 22.6 per cent. That the IFCI has not succeeded in contributing significantly to the industrial development of backward regions is evident from Table 7.3.

TABLE 7.3. Percentage Share of Assistance of the IFCI to Different States 1963 and 1973

	1963	1973
Bihar	6.1	5.1
Kerala	3.9	3.4
Mysore	7.4	6.7
Assam	3.9	1.7
Rajasthan	5.4	3.9
Orissa	4.4	3.0
Andhra Pradesh	5.9	6.6
Uttar Pradesh	6.5	8.6
Madhya Pradesh	0.9	2.3

Source: Compiled by the author from the 25th Annual Report of the IFCI.

In terms of industrywise distribution of assistance also there have been marginal shifts only. On June 30, 1973, for instance, the sugar industry was the largest single recipient of assistance with 22.7 per cent of the total. Metallurgical industries claimed 13.7, engineering industries 13.6 and textiles 12 per cent. These groups claimed more than 60 per cent of the total assistance given by the IFCI. Compared to the earlier period, fertilisers and paper have been getting a larger share of assistance of late. Recently, however, the IFCI has paid attention to the hotel industry.

The IFCI's assistance to cooperatives accounted for only 3 per cent of the total sanctioned in 1948-49. It moved from 20 in 1968 to 31.5 per cent in 1972–73. Again in the cooperative sector sugar units alone enjoyed the lion's share of assistance, about 90 per cent. The diversion of such a large proportion of the IFCI's resources to the cooperative sector away from the privately organised industrial sector for the assistance of which it was primarily designed is open to serious criticism. Among the sugar cooperatives again, the bulk of its assistance went to a single State—Maharashtra. The wisdom of concentrating in one kind of industry and that in a particular region is questionable. It does not satisfy the primary canon of industrial financing—the diversification of the risks of investment. One wonders why the IFCI, rather than the cooperative banking system, has been chosen as the instrument for financing industrial cooperatives. With the institutional machinery of cooperative banks being more effectively developed under the care of the Reserve Bank of India, the time has come for the IFCI to wean itself away from its absorbing interest in the sugar cooperatives.

Again, it was pointed out that the IFCI loans were generally in favour of large firms. It does appear to have an unwarranted bias in favour of the bigger units

within the large industrial sector. Moreover, it has relaxed its efforts to extend special consideration to applications coming from the relatively less developed parts of the country (see Table 7.3).

Although the assistance provided by the IFCI is somewhat unevenly distributed over the various States, it has, nevertheless, to be appreciated that long-term credit is only one of the several factors which go into the establishment of an industry in a particular area. The IFCI cannot create the basic conditions required for the success of an industry. Even in the field of industrial finance, it is required to act on business principles as per Section 6 of the IFC Act, 1948, and as such, can only stretch itself to a point and take limited and calculated risks to foster the establishment of industries in the less developed States. For a major breakthrough, assistance has to be provided in other ways, and possibly through other agencies.

III

Role and Achievement of the State Financial Corporations

The IFCI helps only limited liability companies; it does not meet adequately the medium and long-term credit needs of medium and small-scale industries. To close this gap, the Reserve Bank of India in the early fifties helped establish various State Finance Corporations (SFCs). It also provided technical assistance in organising them and offered advice to them in matters of policy and in operations. Indeed, the SFCs have close relations with the Reserve Bank which has one nominee on the Board of Directors of each of them, who could also function on their respective executive committees. The SFCs generally consult the Reserve Bank in the matter of appointing managing directors and there have been instances when the Reserve Bank has deputed its own officers to work as managing directors. Apart from the statutory provision which specifies that the Reserve Bank should be consulted before the SFCs issue any bond or debenture for the purpose of increasing their working capital, or frame regulations under the SFC Act, the Reserve Bank's advice and assistance are sought by them on important matters of policy, for instance in the investment of their funds. The Reserve Bank has also been given powers, by an amendment of its statute, to make suitable loans to these institutions as and when necessary.

The percentage distribution of the shareholdings of all the SFCs together by class of shareholders as on March 31, 1963, is given below:

1. State Government	46.3
2. Reserve Bank of India	17.5
3. Scheduled banks, insurance companies, etc.	32.5
4. Others	3.7
	100.00

The Reserve Bank also subscribed to their bonds. In addition to the short and

medium-term facilities provided by it, the SFCs get both banking and rediscounting facilities also with it. The Reserve Bank gets periodic reports from these institutions to ascertain the soundness of their operations. Recently, it has been empowered to inspect them. Thus, by various measures the Reserve Bank maintains an effective tie with these financial corporations. In addition, eight of them availed of the credit facilities from the Reserve Bank in terms of Section 17(4A) which enables them to borrow from it for periods up to 18 months. Table 7.4 sets out the broad trends in the loan operations of the SFCs over the years.

TABLE 7.4. Loan Operations of the SFCs

(Amount in crores of rupees)

As on Mar. 31 (June 30 for TIIC up to 1972)	*Number of SFCs*	*Total effective sanctions*	*Total disbursals*	*Total loans outstanding*	*Outstanding loans to small-scale industries*	*Percentage of (6) to (5)*
1	2	3	4	5	6	7
1956	12	7.1	4.2	3.6	Not available	—
1961	15	32.1	22.5	17.0	3.5	20.5
1966	15	108.0	84.1	60.4	11.5	19.1
Fourth Plan						
1971	18	234.5	185.4	128.7	52.0	40.4
1972	18	293.8	225.1	155.8	72.4	46.4
1973	18	363.0	267.9	181.8	91.1	50.1
1974	18	459.3	323.3	216.2	119.9	55.5

It will be evident that although prior to 1966, the SFCs were channeling a major share of their assistance to medium-scale industries, the trend has since been reversed and the bias is now in favour of the small-scale sector. As a matter of fact, in recent years, the lion's share of assistance (65–79 percent amountwise and over 91 per cent numberwise) has gone to the small-scale industries as may be seen from the Table 7.5.

TABLE 7.5. Share of Small-Scale Industry in SFC Loans

(Amount in crores of rupees)

Year (Apr.-Mar.) Fourth Plan	*Loans sanctioned*				*Percentage of*	
	Small scale		*All units*		(1) *to* (3)	(2) *to* (4)
	No.	*Amount*	*No.*	*Amount*		
	1	2	3	4	5	6
1971-72	4736	49.7	4961	63.3	95.4	78.5
1972-73	4599	55.4	4870	78.0	94.4	71.0
1973-74	5140	67.1	5595	104.1	91.9	64.4

The SFC Act was closely modelled on the lines of the original IFC Act of 1948 and is, therefore, subject to the same limitations and shortcomings. Moreover, the legal framework has in effect introduced a straight jacket institutional pattern for all the States without reference to their peculiar regional needs and economic conditions.

Unlike the IFCI, the SFCs have not been authorised to subscribe directly to the equity shares of industrial concerns. They have been allowed to subscribe to 'right' shares only. It is rather curious that while permission has been granted to the IFCI to provide risk capital, it should still continue to be withheld from the SFCs.

Some of the SFCs have been accepting deposits from the public in recent years but the response from the public has been poor. The Working Group on them has stressed the need for them to raise at least a part of their resources through deposits. With a view to making the deposits with such corporations more attractive, the Working Group has further suggested that deposit receipts issued by them be made assignable to third parties, so that depositors can obtain advances against their deposits by assigning the receipts to banks.[1] The Reserve Bank of India is also encouraging the SFCs to build up a depoist portfolio and has asked them to adopt a rate structure which should generally be 0.25 per cent higher than that allowed by the larger commercial banks.[2]

In practice there is hardly any development bank which is known to have relied on this unorthodox and unsound method of raising funds for making medium or long-term industrial loans. The exhortation by the Reserve Bank and the Working Group amounts almost to an open invitation to the SFCs to take steps to attract more deposits. A scramble for deposits by the SFCs, which enjoy a Government guarantee, would be extremely unfair to the banking system; it would prove disastrous for the future working of the SFCs themselves and would pose a problem for the monetary policy of the Reserve Bank itself (for details see Chapters 9 and 12).

The industrywise or purposewise breakdown of the loans and advances (outstanding) of the SFCs reflects that their interest has been mainly in favour of the 'traditional group' of industries. Textiles and food manufacturing industries between them made up 40.63 per cent of the outstandings, while chemicals, basic metal and metal manufacturing industries, paper and paper products and machinery, an assortment of 'non-traditional' industries accounted for 7.84, 11.29, 3.65 and 12.48 per cent respectively.[3] There has been a marked reluctance on the part of the SFCs to extend their operations to the fields of newly developing industries. The management of the SFCs has shown a preference for industries in which the processes of production are simple and do not call for a detailed scrutiny of the schemes at a high level of technical expertise. The financing of 'non-traditional' industries sometimes involves relatively greater risk. The SFCs with their slender resources and burden of subvention liabilities

[1] Report of the Working Group, p. 31.

[2] *Reserve Bank of India Bulletin*, February 1965, p. 190.

[3] *Report of the Working Group on State Financial Corporations*, Reserve Bank of India, 1964, Table IX, pp. 94–95.

have been inclined to concentrate their operations in safer fields rather than venture into unknown spheres. The removal of the statutory ban on equity financing, the creation of a regional pool of technical experts to be maintained by a group of SFCs whose services they may draw upon not only for themselves but also for would-be entrepreneurs, some provision of foreign exchange resources, the fostering of further coordination between the SFCs on the one hand, and banks and other term-lending institutions on the other, more concern with earning prospects and less with tangible security, and last but not least, the development of a more imaginative outlook on the part of the management may induce the SFCs to concentrate more on industries which have a higher growth potential.

As SFCs provide term finance and commercial banks both term and working capital finance to medium and small-scale industrial units, the question of evolving appropriate guidelines for coordinating the activities of the lending institutions in this field has assumed much significance. The main problem is to avoid unhealthy competition between banks and the SFCs. The coordination between banks and the SFCs in this matter is desirable in the larger interest of the medium and small industrial sectors. It is hoped that banks and the SFCs individually will be able to work out mutually acceptable arrangements in this regard.

The conclusion may be drawn that the operations of the SFCs have reached a higher tempo than in the past and they hold out hopes for the future in the matter of the creation of additional employment opportunities through the financing of a large number of successful small-scale industrial units and in the correction of regional imbalances through directing increased amounts of assistance to industrially backward regions. One way for them to ensure a larger flow of resources to finance a higher volume of business would be to take steps for a quicker turnover of their funds. Following the amendment to Section 25(2) of the State Financial Corporation Act, and the liberalisation of the Credit Guarantee Scheme to give a higher guarantee coverage in respect of loans to technicians, if all of the SFCs adopted the required steps, such as the drawing up and implementation of special schemes for financing technician entrepreneurs and also the creation and use of a special class of share capital in terms of the new Section 4A of the Act, their contribution to the creation of a new class of entrepreneurs could be substantial.

IV

The Unit Trust of India: A Critical Analysis

A related aspect of the Reserve Bank's interest in industrial finance as well as in the mobilisation of savings is its initiative in setting up the Unit Trust of India in 1964. The Reserve Bank subscribed to the share of capital of the Unit Trust and is closely associated with its operation; in fact the Act incorporating it provides that the Board of Trustees must be guided by such directives as may be given by the Reserve Bank in the public interest.

The basic principle underlying the Unit Trust is to afford the small investor a means of acquiring a share in the widening prosperity, based on steady industrial growth, of the country which combines the advantages of a minimum risk[4] and a reasonable return. While providing these facilities, the Unit Trust will help, at the same time, in the mobilisation of resources and channelling them into investments, thereby increasing the overall productivity of capital and facilitating the growth of the economy. To enable the Unit Trust to function, it has been provided with an initial capital of Rs 5 crores contributed as follows: the Reserve Bank of India Rs 2.5 crores, the Life Insurance Corporation of India Rs 75 lakhs, the State Bank of India and its subsidiaries Rs 75 lakhs, and scheduled banks and other specified financial institutions Rs 1 crore. The operation of the Unit Trust is based on principles of scientific investment. In consequence, it has in its portfolio a balanced proportion of safe and liquid securities as well as growth of stocks offering prospects of capital appreciation and reasonable return on capital. Thus, the initial capital has been vested by the Trust in a balanced portfolio of securities of various categories.

The general superintendence, direction and management of the affairs and business of the Unit Trust is vested in a Board of Trustees. The Board consists of a Chairman appointed by the Reserve Bank from among persons having special knowledge or experience in commerce, industry, banking, finance or investment, one Trustee nominated by the LIC and one Trustee nominated by the State Bank, two Trustees are to be elected by the institutions contributing to its initial capital but have presently also been nominated by the Reserve Bank of India. In addition, an Executive Trustee has been appointed by the Reserve Bank. There is an executive committee consisting of the Chairman of the Board, the executive Trustee and two other Trustees nominated by the Reserve Bank. This Committee functions in all matters subject to the direction of the Board. In discharging its functions, the Board is required to act on business principles with due regard to the interest of the Unit-holders. In investing the funds of the Trust, attention must be paid to the security of capital as well as to reasonable return—including capital appreciation—on investment. Thus, guidelines have been provided in the regulations for the functioning of the Unit Trust and the employment of its funds. Investments by it in any one company should not exceed 5 per cent of the value of the total investable funds of the Trust or 15 per cent of the value of securities issued and outstanding of such a company, whichever is lower. Further, not more than 5 per cent of the investable funds should be invested in the initial issues of securities of new industrial undertakings. The Reserve Bank exercises overall control over the Unit Trust and has framed general regulations for the conduct of its affairs. It is also empowered to give specific directions in matters of policy involving public interest. However, the role performed by the Reserve Bank with respect to shareholding and supervision of the Trust will, in future, lie with the Industrial Development Bank of India.

The Unit Trust of India aims at building up a balanced portfolio consisting

[4] By transforming primary industrial securities, which are individually risky, into indirect securities, involving much less risk (Gurley and Shaw, *Money in a Theory of Finance*, op. cit., pp. 4 and 59–60).

of both fixed and variable income-bearing securities yielding a reasonable overall return. The Act provides for significant tax concessions to the Trust and the Unit-holders.[5] The grant of relief from taxation is calculated to facilitate the operation of the Unit Trust and to encourage savings by individuals in the form of Units. The Trust has been conceived as a device for achieving the establishment of a socialist society in which the people will own the means of production, and distribution of products will be equitable. Like any other unit trust, the Unit Trust of India will operate on the principle of spreading risk by investing its funds in a balanced and well-distributed portfolio of investments. A small investor, for instance, who invests Rs 100 in the purchase of Units participates in the entire portfolio and derives the advantage that the risk of investment is either eliminated or reduced for him.

Despite the apparent increase in the Trust's sale of Units (Rs 12.6 crores annually during the first five years and Rs 21.8 crores annually during the second five-year period), it has hardly succeeded in its endeavour to mobilise a large volume of savings. This is clear from Table 7.6 which gives a comparative picture of collections by other agencies.

TABLE 7.6. Unit Trust of India Sales Compared with Collections by Other Organisations

(In crores of rupees)

Year	*Premium collected by LIC (Apr. to Mar.)*	*Increase in scheduled banks deposits**	*Small savings (net collection)*	*Net sales of units*
The Third Plan				
1964-65	162.3	263.2	128.0	18.73
1965-66	179.8	362.0	150.8	1.06
Annual Plans				
1966-67	197.0	470.4	117.6	7.25
1967-68	213.0	372.7	122.4	14.08
1968-69	234.8	460.4	117.6	15.49
The Fourth Plan				
1969-70	268.4	675.1	127.0	20.79

* Calendar years adjusted for PL 480 Fund.

The data for the Fourth Plan will no doubt continue to confirm the same pattern in view of the trend of the phenomenal growth of deposits in the commercial banking and nonbanking companies' sectors although there was

[5] On January 7, 1975, the Government of India issued a special ordinance. Under this, an income up to Rs 2,000 exclusively from Units, will be totally exempted from income tax. This is over and above the existing exemption limit of Rs 3,000 on income from Units and other specified categories of investment. What the new tax exemption really means is one can have Units worth Rs 23,500 and get a sure and steady income from them without paying income-tax.

increase in the sale of Units from Rs 20.79 crores in 1969-70 to Rs 30.3 crores in 1973-74.

To sum up, the Unit Trust of India has started to play a vital role in harnessing the savings of society. It is essentially a financial intermediary to pool the investable resources of numerous subscribers, particularly the small investors. A classification shows that salary and wage earners constitute the largest single group investing in Units. They accounted for 50 per cent of the applications and absorbed 40 per cent of the Units sold.

The most important reason for the initial lack of interest of investors in the Unit scheme in 1964 is the monotony of having a single scheme or plan. In the UK and the USA unit trusts and mutual funds are doing booming business because they come forward periodically with a variety of investment plans. Investors have a choice between the various schemes of the trusts which offer a stable capital value with a rising income or a steady income with capital appreciation. Unless the Unit Trust of India endeavours to retain the public interest continuously, by offering new plans and variety, it cannot hope to win over investors or to remove their indifference and inertia.

In the UK and the USA, investors can choose not only between the various savings plans of the same trust but between different trusts also. In India the trouble is that there is a single trust in a monopolistic position, it just does not have the incentive or the initiative to attract investors.

The slow rate of savings mobilisation also affects the Unit Trust of India in other ways. It has to maintain a large organisation and is unable to meet its expenses out of the 5 per cent margin available from the income allocated to the Unit capital for distribution among Unit-holders. Only if the scale of operations of the Unit Trust grows adequately will it be possible for it to meet its expenses from the permissible margin of 5 per cent. The future of the Unit Trust movement thus rests on its ability to mobilise savings in a substantial way. It is time for new plans and attractions to make their appearance.[6]

The Trust, in particular, has failed to reach rural areas where incomes are now rising. Its structure is monolithic and basically centralised. It has been primarily concerned so far with a group of investors interested in good yields with stability. Under these circumstances, in a large country like India, similar trusts with comparable fiscal benefits and supervision by relevant authorities, are clearly warranted, both in the private and in the public sectors. The other policy issue is concerned with the organisational structure and managerial personnel of the Trust. The somewhat unnecessary conservatism of the Trust, reflected particularly in its investment policy, to a great extent, is due to the combination of management and trusteeship, in sharp contrast with the practice in other countries. A divorce between management and custody with well-organised rights and duties of all concerned would, perhaps, be a better arrangement.

[6] The Unit-linked Insurance Plan has since been introduced. Sales of Units under the Plan amounted to Rs 33 lakhs during 1973-74 as against Rs 13 lakhs in the preceding year.

V

Operations of the Industrial Development Bank of India: Its Contributions to Industrial Development

A major institutional development in the sphere of industrial finance was the enactment of legislation for the setting up of the Industrial Development Bank of India (IDBI) in 1964. The IDBI is a wholly-owned subsidiary of the Reserve Bank of India. The authorised capital of the IDBI has been fixed at Rs 50 crores but, with the prior approval of the Government, it may be increased to Rs 100 crores by the Reserve Bank. The issued capital is Rs 10 crores which may be increased from time to time by the Reserve Bank with the prior sanction of the Central Government. The entire issued capital has been subscribed by the Reserve Bank. The initial paid-up capital of Rs 10 crores has since been raised to Rs 20 crores. The IDBI acquired, it may be recalled, a 50 per cent interest in the IFCI with effect from August, 1964. It can borrow from the Reserve Bank for short, as well as for long, periods. For this latter purpose, the Reserve Bank of India set up from its profits, simultaneously with the establishment of the IDBI, a National Industrial Credit (long-term operations) Fund with an initial contribution of Rs 10 crores and a promise of five more annual contributions of not less than Rs 5 crores a year.

The establishment of the IDBI was called for, according to the Governor of the Reserve Bank of India who is also the Chairman of the IDBI,[7] not only to coordinate the operations of the various term-lending institutions but also to promote really large-scale enterprises which require the mobilisation of the resources of the several financing agencies including the capital market. The role of the IDBI has been envisaged by its Vice Chairman[8] as the apex of an integrated structure of banking and financial institutions catering for the long-term and medium-term financial requirements of large-scale and medium-sized industry. It will not compete with, but will complement and supplement, the operations of other financial agencies.

The IDBI has been functioning firstly, as a coordinating agency, secondly, as a refinancing device, thirdly, as an investment of direct financing, and last but not the least, as a promoter of key and other industries. The role envisaged for it is not merely that of a financing institution, but of a promotional agency with special responsibility to develop certain vital sectors of the economy. It is also expected to function as a developmental agency, according to the Governor of the Reserve Bank of India, to fill gaps in the industrial structure with regard to the industrial priority laid down and finance such priority projects which would, of necessity, require long gestation periods to become financially viable.[9]

[7] Speech by Shri P. C. Bhattacharyya, Chairman of the IDBI on the occasion of the Bank's inauguration, Bombay, July 3, 1964.

[8] *Reserve Bank of India Bulletin*, February 1965, pp. 195–196. Madan, B. K., "Industrial Finance and the IDBI".

[9] P. C. Bhattacharyya, *Commerce Pamphlet*–6, p. 8.

The existing agencies for the provision of industrial finance frequently operate in the same field with hardly any demarcation of their specific spheres of activity; they may be competing with one another and their functions may also be overlapping. Therefore, it was considered necessary to establish a proper relationship among the various industrial financing institutions and to provide leadership to all of them by a central coordinating agency. Thus, the IDBI was formed and it is expected to coordinate the functions and working of institutions which are mature and have already gathered a great deal of experience in their particular fields and some of which can themselves assume the responsibilities of a coordinating agency.

The IDBI, apart from being a coordinating agency, will function as a development financing institution as well. Its statute gives it wide latitude in regard to the forms of its assistance. In its capacity as a financial corporation, it will provide direct assistance in the form of loans and advances, or participate directly by subscribing to, purchasing or underwriting issues of stocks, shares, bonds or debentures. It can also guarantee deferred payments due from industrial concerns and loans raised by them in the open market or from specified institutions. It will also give fresh strength to the existing term-lending institutions by providing refinance for periods other than purely short-term, and by supplementing their capital and other resources.

As a refinancing agency, the IDBI will refinance

(i) long-term loans repayable between 3-25 years which may have been granted by the IFCI, the SFCs or any other notified financial institution to industrial concerns;

(ii) medium-term loans repayable between 3-10 years granted by any scheduled or State cooperative bank to any industrial concerns;

(iii) loans repayable between 6 months-10 years granted by banks, cooperative societies, and financial institutions like the IFCI, SFCs, etc., to industrial concerns or a group of industrial concerns in connection with the export of capital goods or other commodities from India.

As a result of the refinancing functions assigned to the IDBI, the Refinance Corporation for Industry has become superfluous and has therefore been acquired and converted into a wholly-owned subsidiary of the IDBI.

The Reserve Bank of India's long-term, medium-term, and short-term financial assistance to the IDBI, IFCI and the SFCs through subscriptions to their share and bond issue and also under Sections 17(4B)(b), 17(4A) and 17(4)(a) of the Reserve Bank of India Act is disclosed in Table 7.7.

The performance of the IDBI, a wholly-owned subsidiary of the Reserve Bank of India, has been disappointing. The bulk of financial assistance was sanctioned to traditional industries such as cotton textiles, cement, paper, etc. It has exhibited little initiative so far in the exploration of investment possibilities and also for the stimulation of the capital market. A development banking institution must have skilled, experienced management with an opportunity to exercise independent judgment imaginatively.[10] Unfortuntely, the Indian

[10] Diamond, W., *Development Banks*, op. cit., p. 85.

TABLE 7.7. Reserve Bank of India and Industrial Finance Fourth Plan Period

(In lakhs of rupees)

At the end of	A. Long-Term Finance to						
	Industrial Finance Corporation		State Financial Corporations		Industrial Development Bank of India		Others (b)
	Shares (a)	Bonds	Shares	Bonds	Shares	Bonds	
	1	2	3	4	5	6	7
1960-61	103	200	235	—	—	—	—
1965-66	—	220	243	21	1000	—	309
			Fourth Plan Period				
1969-70	—	220	243	18	2000	—	627
1970-71	—	220	243	18	3000	—	2,984
1971-72	—	220	243	2	4000	—	7,833
1972-73	—	220	243	2	4000	—	9,527
1973-74	—	220	243	2	5000	—	15,444

(a) From August 1, 1964, all the shares of the Industrial Finance Corporation of India held by the Reserve Bank of India have been transferred to the Industrial Development Bank of India.

(b) Relates to the data on long-term finance to Industrial Development Bank, for purposes of purchase of or subscription to stocks, shares, bonds, debentures issued by Industrial Finance Corporation, SFCs or any other notified financial institution or for purposes of any other business of Industrial Development Bank.

Outstandings as on last Friday	B. Medium-term finance to		C. Short-term finance to State Financial Corporations†**
	Industrial Finance Corporation of India @	State Financial Corporations†*	
	8	9	10
1960-61	51	—	13
1965-66	82	77	52
		Fourth Plan Period	
1969-70	—	222	29
1970-71	166	172	71
1071-72	205	443	42
1972-73	—	388	42
1973-74	40	462	2
Mar. 73	—	388	42
Apr. ,,	—	401	12
May ,,	—	458	12
June ,,	268	476	19
July ,,	154	489	17
Aug. ,,	61	166	1
Sept. ,,	—	168	10
Oct. ,,	141	131	17

(Contd.)

	8	9	10
Nov. 73	70	173	5
Dec. ,,	—	291	5
Jan. 74	—	405	—
Feb. ,,	33	392	20
Mar. ,,	40	462	2

@ Under Section 17(4B)(b) of the Reserve Bank of India Act.
† Including Tamil Nadu Industrial Investment Corporation.
* Under Section 17(4A) of the Reserve Bank of India Act.
** Under Section 17(4)(a) of the Reserve Bank of India Act.
Source: *Report on Currency and Finance*, Reserve Bank of India, 1973-74, p. S49.

institution is sadly lacking in the venturesomeness essential to stimulate the private sector. The contribution of a development bank, of course, has to be judged not merely by the amount of funds it makes available but by the total investment that it is able to push through. Of late, the problem of regional disparity in the industrial growth rate has assumed alarming proportions and has become a source of growing tension. The problem of regional imbalance has been partly mitigated by providing monetary incentives to backward states at a concessional rate. Of Rs 51 crores of assistance sanctioned by the IDBI for projects in the backward areas since June 1970, as much as Rs 36 crores (46 per cent as against a mere 14 per cent in 1972–73) was on a concessional basis in 1973–74 alone.

From Table 7.7 it is clear that in relation to needs, both in terms of magnitude of investment outlays and of diversifying the industrial structure, a large gap still remains. On a liberal and lenient basis it may be concluded that, particularly at a time when the capital market happens to be in a state of weakness, the pace of industrial investment has been sustained largely by the activities of the specialised corporations with the support of the Reserve Bank of India. (Details of the interest rate structure of the IDBI and a summary of its operations are given in the Annexures at the end of this chapter.)

VI

Credit to Small-Scale Sector: Credit Guarantee Scheme

Another sector of industrial finance in which the Reserve Bank has taken the initiative is that of credit to small-scale industry. It has sought to stimulate the flow of bank credit to this sector in a variety of ways—by granting preferential treatment of banks' lendings to it, and more importantly, by operating a credit guarantee scheme for small industry.

The Industrial Policy Resolution of 1948 as well as of 1956 assigned a significant role to small-scale industry in the overall industrial growth in the country. To meet the requirements of credit for the small-scale industry, it was envisaged that while the Government credit agencies would have to play a

promotional role, especially in the early stage of growth, the financing institutions should gradually take over the responsibility of meeting the credit needs of the sector. A radical reorganisation of the capital market through public intervention was, therefore, taken up to ensure an increasing flow of institutional finance to meet the needs of the new industrial growth under Plan programmes. The process that started with the nationalisation of the Imperial Bank has now reached the stage of social control and nationalisation of major banking institutions, providing for definite directions to the commercial banks to reorient their credit policies to meet the requirements of the priority sectors of the economy including small-scale industry.

A phenomenal growth of modern small-scale industries has taken place in the country during the Plan periods. Numerically, the small-scale sector today predominates the industrial map of the country.

In providing institutional finance for the small industries, the Reserve Bank has been playing a vital promotional role. Acting as the agent of the Government of India, it formulated a credit guarantee scheme[11] for providing guarantees to the financing institutions for a major portion of the finances advanced by them to small industries. The basic objective of the scheme was to encourage the supply of institutional credit to small-scale industries. The actual percentage of the coverage under the scheme depends on the limit of the advance sanctioned as well as on the amount involved in default.

The Credit Guarantee Scheme for small-scale industries administered by the Reserve Bank of India is given in Table 7.7a.

TABLE 7.7a. Credit Guarantee Scheme for Small-Scale Industries Fourth Plan Period

(Amount in lakhs of rupees)

As at the end of March	*Guarantees outstanding*		*Net amount of commission collected (cumulative)*	*Advances under default*		*Claims paid on account of invocation of guarantee (cumulative)*		*Net surplus* accrued to Government (cumulative)*
	No.	*Amount*		*No.*	*Amount*	*No.*	*Amount*	
	1	2	3	4	5	6	7	8
1960-61	566	175	—	—	—	—	—	—
1965-66	12816	4,970	24	54	18	66	9	18
			The Fourth Plan Period					
1969-70	92755	61,871	137	407*	123*	154	20	123
1970-71	—	74.684	184	1.799	589	190	25	168
1971-72	—	86,387	263	4,082	1,352	258	36	237
1972-73	—	103,633	349	6,538	1.905	406	60	310
1973-74	—	139,592	452	9,582	2,873	808	90	393

Note: The figures in column Nos. 3 and 8 represent the position as at the close of the previous half year. *Estimated.

Source: *Report on Currency and Finance*, 1973-74, p. S70.

[11] The Industrial Finance Department in the Reserve Bank of India which administers this Scheme works closely with the IDBI and is supervised by the same Deputy Governor who functions as the Vice-Chairman of the IDBI.

Under the scheme of social control and bank nationalisation small industries have been declared as one of the priority sectors of the economy, along with agriculture and exports, for credit advances from the banking institutions to support their production programme. The Banking Laws (Amendment) Bill has given wider scope to the Reserve Bank for issuing directives to the commercial banks in implementing credit policies for the priority sectors of the economy. Even before the enactment of the bill, the Reserve Bank had initiated a number of measures to encourage further flow of institutional credit to small-scale industries. Under the Reserve Bank's credit policy announced in 1967, the increase in commercial banks' advances to the priority sectors, which include small industries, over the average of such advances during the period May to October 1966 for the slack season and November 1966 to April 1967 for the busy season, would be taken into account as part of their liquid assets for the purpose of computing the net liquidity ratio of the banks. A further liberalisation towards priority sectors was made with the Reserve Bank's announcement in January 1968 that the total increase in commercial banks' advances over the base period to the small industries guaranteed by the credit guarantee organisation would also be eligible for refinance at a concessional rate of 4.5 per cent. Steps have been taken by the Reserve Bank for further liberalisation of the operation of the Credit Guarantee Scheme; these are the introduction of a revised form of guarantee application and opening of regional offices of the Industrial Finance Department at Calcutta, Madras, and New Delhi, besides Bombay, with a view to expeditious disposal of the applications. The newly opened regional offices have also been directed to maintain close liaison with the credit institutions, Government and other agencies concerned with the financial and other needs of the industry, especially the small-scale sector. The Boards of Management of most of the major commercial banks have also been reconstituted with the inclusion of representatives from all the priority sectors through the good offices of the Reserve Bank. The cumulative effect of all these actions has resulted in an appreciable rise of advances to small-scale industries from the scheduled commercial banks.

The State Bank of India has also announced the introduction of a new scheme on liberalised terms to finance small entrepreneurs with technical ability and worthwhile projects but lacking in financial resources. The scheme marks a major departure from the earlier one inasmuch as it puts more emphasis on immaterial assets in the shape of character and ability to run the industry successfully rather than on the material assets possessed by the entrepreneur. The impact of the scheme is yet to be felt.

From a review of the role institutional credit has so far played in meeting the overall credit requirements of the small-scale industries, it is possible to pinpoint the existing constraints operating against the enlargement of the flow of assistance from the financing institutions to this sector. The executives of the banks point out that the structural and organisational weakness of small-scale industry is one of the biggest impediments towards the enlargement of the flow of institutional credit to this sector. The weaknesses are: (i) Unsatisfactory debt-equity ratio; (ii) non-maintenance of proper accounts and balance sheets and (iii) lack

of modern management practice. On the other hand, the general grievance of the small entrepreneurs is that the banks are very much security conscious and unless the emphasis on material security is changed, small industries cannot hope to secure the major portion of their credit requirements from them.

The time has now come to change the traditional concept of security linked to material assets to a modern concept linked mainly to immaterial assets in the shape of character and the technical ability of the entrepreneur. The banking institutions will have to provide the modern sophisticated industries with the necessary finance relying more on their immaterial assets than on material security to enable the banks to play this historic role. The Credit Guarantee Scheme may have to be further liberalised. The Reserve Bank has so far played a dynamic role in this direction. In continuation, it should advise a few of the leading commercial banks to adopt at least the technician-entrepreneur scheme of the State Bank of India immediately.

The acceptance of immaterial assets as the principal security by the banking institutions implies a complete confidence of the banks in the entrepreneurs' character, ability, and the viability of their projects. To generate such a spirit of confidence the small industries themselves have a vital responsibility to discharge, just as the central bank as well as the commercial banks have social obligations to reorient their attitudes in the context of the existing and future developmental needs of the country.

VII

Observations

There is, indeed, a very bright future for Indian industry. A firm base has been laid as a result of the efforts made by the nation in the last twenty years or so for the development of modern industry. On the supply side, our industrial machinery is capable of producing an ever widening range of products from the simplest to the most highly sophisticated types. India is becoming increasingly self-reliant in capital goods and this trend is bound to gather further momentum. It is true that the raw material supply position needs to be improved. A part of this should come from the improvement of agriculture which can augment the supply directly, or indirectly through earning foreign exchange through exports. But a part will also have to come from the efforts of industry itself which must assume a larger export obligation. On the demand side, Indian industry can confidently look forward to a rapidly rising demand curve particularly as the rural sector becomes more and more prosperous as a result of the massive investments that are being undertaken in agriculture now and as its standard of living rises. Broadly speaking, the authorities in the Reserve Bank of India have been pursuing a promotional or developmental credit policy since the commencement of the planned economy and have not been unmindful, as we have seen, of the needs of the industry in the matter of resources—physical or monetary. It is up to industry, therefore, to make the best use of those opportunities. Those who manage industrial enterprises should bear in mind that in

return for all the assistance that they receive from society for their development, they also have some obligations towards it. The first and the most important of these is to have a highly efficient industrial organisation. The resources that the nation makes available to them must be used in a manner that will give the maximum possible productivity. Secondly, the industry has to make a positive contribution to the growth of the economy by setting apart as much as possible for investment. In developing countries such as India not only has industry to generate resources for itself but it also has to provide resources which will make growth in the various backward sectors of the economy possible. Thirdly, and this is a point which has particular relevance in the current context, the ordinary investor should feel assured that he is getting a fair deal and that his interests are being looked after adequately by the management. If this were done, the Indian investor would come forward and make his contribution to the industrial development in ample measure.

Most of the central banks in the underdeveloped countries have assumed, in recent years, promotional roles in initiating and developing financial institutions, lending both long and short, "although such a policy is considered to be unorthodox and unconventional in the lexicon of traditional central banking."[12] To conclude, the positive, promotional role which the central bank of a developing nation has to play involves undertaking a multiplicity of functions and the use of a variety of techniques. The total effect of the wide gamut of activities undertaken by the Reserve Bank of India has brought about, in relation to the credit requirements of the different sectors of the economy and the activities of the institutions designed to meet them, an extension in the scope of operations, expansion in the scale of financing, improvement in the efficiency of service, and flexibility in procedure and techniques. How far the central bank of a country should go in taking up these different functions will have to be decided in each case in the light of the special circumstances relevant to it. As conditions differ from one field to another and again, from one stage of development to another, it is important that the approach in this regard should be rational and flexible rather than doctrinaire and rigid. Basically, the responsibility of the central bank is to see that the expansion of bank credit does not add to the inflationary pressure in the economy while the credit needs of production and development activities are fully met. There should, therefore, be no reason for conflict between these functions of the central bank and the more conventional functions of monetary and credit regulation, for these are complementary. In fact, each has to be pursued in close coordination with the other, as the task of the central bank is to combine the control of credit with the positive development of credit institutions. The development of credit institutions, again, can be of great importance in the stimulation of a capital market which is an important objective of many central banks. To the extent that the promotional role of the Reserve Bank of India helps ensure the efficient working of the financial institutions and the proper use of credit for investment in productive and other

[12] *Per Jacobsson Foundation Lecture*, delivered by Dr. C. D. Deshmukh on October 1965. "The Balance Between Monetary Policy and other Instruments of Economic Policy in a Modern Society."

desirable fields, it should strengthen the Reserve Bank in maintaining monetary stability in a period of economic growth.

The IDBI is legally a separate institution from the Reserve Bank but yet it is closely associated with it in its efforts to guide, supervise and undertake the entire range of activities relating to industrial finance. Indeed, this close association of the IDBI with the Reserve Bank has helped the IDBI overcome many of the problems of organisation and personnel, facilitated its refinancing, rediscounting and other operations with the banks and the SFCs, and enabled it to evolve a structure of policies appropriate to the emerging monetary and economic situation. This feature of the evolving pattern and structure of the financial institutions in India has added a new dimension to the theory and practice of central banking. The IDBI assumed a leading role in new fields and granted substantial assistance to projects which because of technological compulsions are of a large size and require substantial capital investment. The major tasks of the IDBI in the next few years will be related to the new initiatives it has taken since 1970 with regard to its promotional role and functions. The years 1970-71 and 1971-72 represented a period of consolidation as well as exploration. As a part of consolidation, its structural-functional setup was streamlined and its methods and criteria sharpened. Exploration was with regard to its promotional function, a new function pregnant with great possibilities. After it attained a degree of maturity in the field of development finance, the IDBI set up in 1970 three regional offices and opened a branch office practically for each State to develop an initmate contact with the economic situation and potentialities in the different regions and States of the country, in order to facilitate a widely diffused process of viable industrialisation. The second major step related to the identification of project ideas in backward areas and districts. The real problem is likely to be with regard to management of the identified projects. To tackle this problem, the IDBI may have to set up, with the assistance of other institutions in the field, a management consultancy service at both an all-India and State levels.

A recent legislation (Public Financial Institutions Laws (Amendment) Bill passed by the Lok Sabha on August 5, 1975) delinks the IDBI from the Reserve Bank setup and seeks to coordinate the activities of various developmental financial institutions. The restructured IDBI, delinked from the Reserve Bank, is now in a definitely better position to formulate policy decisions independent of partisan politics and pressures from the central bank. Although one of the Deputy Governors of the Reserve Bank will act as a member of the restructured Board of Directors, his authority will be limited to that of an ordinary member in the administration, in decision making functions it will be nothing more than that. The IDB of Canada and the Industrial Development Bank of India are two rare instances of complete central bank ownership. It has been long debated whether development banks should be wholly-owned and administered by the central bank. The conditions in the capital market of the two countries are quite dissimilar. Canada is a mature economy whereas India is a backward economy. It would, therefore, be misleading to draw the same analogy from the Canadian situation. None, however, questions the competence, ability and

aptitude of the Board of Directors in central banking functions. But the same Board, already overburdened, could do little justice in the matter of framing the operational policies of a development bank, the principles and problems of which are quite different from those of a central bank. The same Board, again, cannot have the required expertise necessary for the administration of industrial loans. It may be pertinent to point out that the Reserve Bank of Australia, since 1959, has been retreating from non-trading and industrial financing business and approximating to itself the concept of a true central bank.

The main objective of restructuring the IDBI is to enable it to play, more positively than before, its role as an apex financial institution in financing and promoting industrial development and coordinating the functioning of term-lending institutions. The main thrust of the IDBI in the future will be that of an innovator imparting new directions in the sphere of industrial finance. Besides ensuring that present resources are diverted to socially more desirable channels, it will also evolve policies that would go to augment financial and entrepreneurial resources to help a quicker realisation of India's socio-economic objectives. It will also play a very important role in bringing about a regionally well-balanced process of industrialisation.

In addition to the constant endeavour for a quantitative increase in the IDBI's assistance to industry, it will initiate new types of lending for fulfilling its new and enhanced responsibilities. Its principal functions and operations at the head office have been entrusted to two separate wings—the Domestic Finance Wing and the International Finance Wing—each having the same status and each in the charge of an Executive Director who has knowledge and expertise in his own field. The Domestic Finance Wing will handle all aspects of domestic project assistance including selection and scrutiny, financing and follow-up. The accent will be on time-bound programmes for the procedures and operations of the Wing so that avoidable delays are eliminated. The export department has been restructured into a strong International Financing Wing which will offer improved and wider financial and advisory services to engineering exporters and function as an export bank.

Annexure 7.i

The interest rate structure of the IDBI effective from July 27, 1974, is given in the accompanying charts.

Interest Rate Structure of IDBI Effective from July 27, 1974

1. *Direct assistance to industrial concerns (other than for exports)*	
(a) Normal rate	10.25 per cent p.a.
(b) -to units in the backward areas.	8.50 per cent p.a.
2. *Refinance*	
(a) Normal rate	8.50 per cent p.a.—Ceiling on the rate to be charged by the financial institutions at 12.00 per cent.
(b) Special rate for small-scale industrial units covered under C. G. S. & Technician entrepreneur scheme	7.00 per cent p.a. provided the financial institution does not charge more than 10.50 per cent.
(c) Special rate for units in the backward areas	5.50 per cent p.a. provided the financial institution does not charge more than 9.00 per cent.
Under IDA line of credit	*Foreign currency component*
(a) Small scale industries covered under C. G. S. & Technicians entrepreneur scheme and units in specific backward district	8.00 per cent p.a. provided the financial institution does not charge more than 10.50 per cent.
(b) Other cases	8.25 per cent p.a. provided the financial institution does not charge more than 11.00 per cent.
3 *Export credit*	
(a) Refinance against medium-term export credits	5.50 per cent p.a. provided the bank does not charge more than 7.00 per cent.
(b) Participation export finance scheme and Buyers' credit scheme	The rate of IDBI's portion of the credit is such that after taking into account the participating bank's rate, the average rate to the exporter on the entire credit will generally be 6.50 per cent.
4. *Bills rediscounting scheme*	
Unexpired usance of bills/promissory notes	
(a) 6-36 months	9.00 per cent p.a. provided the maximum discount rate by bank is 10.00 per cent.
(b) Over 36 months and up to 84 months	8.50 per cent p.a. provided the maximum discount by bank is 9.50 per cent.

Annexure 7.ii

Interest Rate on Assistance to Breweries and Wineries

	Per cent per annum	
	IDBI rate	*Ceiling on primary institution's lending rate*
1. Direct loans to industrial concerns	12.25	—
2. Refinance of industrial loans	10.50	14.00
3. Rediscounting of machinery bills		
Unexpired usance of bill		
(a) Over 6 months and up to 36 months	11.00	12.00
(b) Over 36 months and up to 60 months	10.50	11.50

Rate of interest on direct loans from IDBI to winery and brewery units located in specified backward areas will be 10.25 per cent per annum. The refinance rate in respect of units in the specified backward areas will be 8.50 per cent per annum with corresponding ceiling on primary lenders rate at 12.00 per cent per annum.

(Ref. No. 348/EPD. 7(10)-74/75, dated August 1, 1974.)

Annexure 7.iii

Summary of Operations of the IDBI

The financial assistance sanctioned and disbursed by IDBI since its inception in July 1964 to June 1972 is summarised in the Table below.

(In crores of rupees)

Type of assistance	*Assistance sanctioned (effective)* July 1964-1972	*Assistance disbursed*
1. Direct loans to industrial concerns other than for exports	194.2	99.2
2. Underwriting of and direct subscription to shares, debentures, etc., of industrial concern (including rights shares)	41.3	21.4
3. Refinance of industrial loans	151.8	142.1
4. Rediscounting of bills	135.2	115.3
5. Refinance of export credits	27.2	21.4
6. Direct loans for exports	48.4	25.1
7. Subscriptions to shares, bonds and debentures of financial institutions (excluding purchase of shares of IFCI)	36.6	33.9
Total of 1 to 7	634.7	458.5*
8. Guarantees for loans and deferred payments	26.9	19.1†
9. Export guarantees	1.8	1.7†

* Figures do not add up to the total due to rounding off.
† Guarantees executed.

Annexure 7.iv

Operations of Unit Trust of India

(Number in thousands; amount in lakhs of rupees)

Year ended June	*Units sold*		*Units repurchased*		*Units outstanding**	
	Number of applications	Amount	Number of applications	Amount	Number of applications	Amount
1970-71	62	18,00	13	3,19	3.84	92,25
1971-72	61	15,08	10	2,60	4,35	104,72
1972-73	82	23,04	11	2,97	5,06	124,79
1973-74	1,00	30,31	14	3,68	5,92	151,43

Note : (1) Amounts set out in this statement relate to the face value of units, viz. Rs. 10/- per unit.

(2) Figures include units sold under (i) Reinvestment plan, 1966 (ii) Voluntary savings plan, 1969 and (iii) children's Gift plan, 1970, including fractional units allotted by reinvestment of dividend. * End of the period.

Source: *Report on Currency and Finance,* Reserve Bank of India, 1973-74, p. S82.

8

Central Banking Policy and Term Loan Innovations in Commercial Banking Practice

The Dynamic Role of the Commercial Banks in Term Credit

A study of the role of the Reserve Bank of India in the sphere of industrial finance will remain incomplete if the central banking policy towards term loans[1] by the commercial banks is not analysed in proper perspective.

The particular emphasis on industrial development in the Five Year Plans has raised the question of availability of term finance in the industrial fields. The Government of India in collaboration with the Reserve Bank of India set up a number of development banks in recent years to serve the needs of agricultural and industrial finance. The performance of the development banks in the sphere of industrial investment is not free from criticism as to their methods of handling cases and promptness in responding to demands for term finance. The deterioration in the climate for industrial investment is the recurring theme of the Annual Reports of the development banks. The overall requirements of industry and mining in both the private and public sectors in the subsequent Plans will continue to grow. All in all, commercial banks will perforce have to play a dynamic role in providing term credit in the changing economic climate.

II

Legislative Clearance in Foreign Soil

In the USA as early as 1935 the United States Banking Act required the

[1] In this study the expression 'term loan' has been used to mean a loan to a business which is repayable after the lapse of one year according to the terms of agreement between the borrower and the lender. The duration of the loan usually extends over more than one year but does not exceed ten years and repayments are usually made serially over the life of the loan out of future earnings.

Federal Reserve Banks to extend credit to member banks against any 'acceptable assets'. In Mexico, official policy has deliberately led the commercial banks into greater participation in the capital market. The central bank appears to have achieved a degree of success in directing commercial banks into medium and long-term loans and into industrial securities. The shift took place under the influence of the reserve requirements imposed by the Bank of Mexico, which offered a strong incentive to commercial banks to extend medium-term loans to industry. At times, Chartered Banks in Canada, too, have made excursions into the field of longer term financing. Since 1960, under the Small Business Loan Act, these banks have been able to make term loans to small business otherwise unable to obtain credit on reasonable terms. Such loans are also guaranteed by the Canadian Government.[2] A significant feature of Australian Trading banks in recent years is their close association with hire purchase finance companies through the acquisition of shares in them. In April 1962, following an agreement with the Reserve Bank, which had till then encouraged the limitation of trading bank lending to short-term purposes, each of the major trading banks established revolving term loan funds. The defined purpose of the term loan funds is to provide fixed loans for capital expenditure in the rural, industrial, and to a lesser extent in the commercial fields, and also to finance exports. In the farm sector, term loans are made for developmental purposes, including the purchase of land, heavy equipment, clearing, pasture improvement, building and fencing, and livestock improvement.[3]

A changed trend in the banking legislation in underdeveloped countries seems to be in favour of larger participation by the commercial banks in term financing. Thus, on the recommendation of the World Bank survey mission which visited Colombia in 1949, the law was changed to allow the banks to lend for a period up to five years for certain economically useful purposes. In Cuba also the mission strongly recommended an increase in term lending by the savings banks.[4] The Commercial banks in Guatemala have been permitted to grant loans with maturities of 1-3 years. For example, Articles 41 and 43 of the Bank Law of Guatemala authorise banks to acquire bonds and securities issued by first class private enterprises. The Dominican Republic has authorised commercial banks to participate in long-term credit even for periods exceeding three years with the authorisation of the Superintendent of Banks. Similarly, the Paraguayan legislation of 1944[5] permitted grant of loans exceeding three years with the approval of the banking Superintendent. The 'term loans' business developed by American commercial banks thus finds an echo in these legislative provisions. The Central Banking Act, 1950, of Korea[6] clearly permits banks to engage both in commercial banking and long-term financing. Again the

[1] Thomas, Rollin, G., *Our Modern Banking and Monetary System*, Prentice-Hall Inc., Englewood Cliffs, N. J., 1964, p. 263.

[2] For details see *Reserve Bank of India Bulletin*, April 1962 and *Commerce*, Annual Number, 1967.

[4] Diamond, W , op. cit., p. 44 and also see *Report on Cuba*, IBRD, Baltimore, 1951, pp. 587-588.

[5] Article 23, General Banking Legislation, Paraguay.

[6] Article 19.

Banking Law of Guatemala, 1946,[7] provides that one single institution can act both as a commercial bank and as a mortgage bank provided separate departments are established to carry out the respective functions. It may be noted here that the Indian Banking Companies Act, 1949 (now the Banking Regulation Act) did not expressly prohibit the holding of obligations of private enterprises nor the grant of loans against real estate. The *Report of the Committee on Finance for the Private Sector in India,* 1954 recommended a degree of 'mixed' banking when it suggested that "the Reserve Bank can facilitate larger investment by commercial banks and other financial institutions in private industry by suitable adjustments in its lending and discounting practices" and that banks should increase their investment in industrial securities, make larger advances against such securities and form a syndicate with finance companies to underwrite new industrial securities.[8]

III

Cautious Revival of Formal Term Lending

Commercial banks have branched out into newer forms of industrial financing of which two are particularly important: medium-term lending and underwriting of new issues of industrial securities. There is a great measure of agreement on the desirability of taking up at least medium-term financing (repayable within a period of 1-5 years) by the commercial banking system. It is interesting to note in this connection that commercial banks in many countries have been following neither the orthodox British model which restricts itself to, at least in theory, more or less self-liquidating short-term credit, nor the nineteenth century German model in which the banks are deeply involved in the fortunes of industry, but the modern American model which openly recognises term loans business. Commercial banks have thus made excursions into hitherto unpractised fields—term financing—and have widened their horizons.

Thus, a cautious revival of formal term lending has taken place under the stresses of the postwar demands for reconstruction, modernisation, and expansion. Even in the UK, which is undoubtedly the home of the orthodox code of commercial banking, there exists at present a volume of medium-term as well as long-term debts which, however, the banking system 'masquerades as short-term lending'. Despite the tradition of British commercial banking, since the early nineteenth century the commercial banks have done an appreciable part of the industrial financing of continental Europe and the USA.[9] In recent years there has been such a boost in term loans, both in terms of number and amount, that this type of operation has been characterised as a 'recent development' in the commercial banking system of the world. According to Professor Robinson, "the biggest single change in the nature of commercial bank lending since the 1930s has been the growth of term loans."

[7] Articles 34 and 38.

[8] *Report of the Committee on Finance for the Private Sector*, Bombay, 1954, p. 42.

[9] Diamond, W., *Development Banks*, Economic Development Institute, Baltimore, 1957, p. 42.

It is hoped that the changes in the nature of the financial needs of business in a developing economy will favour the further growth of term advances in times ahead. According to Professor Robinson[10] again the "fundamental changes in the nature of business financial needs may favour the further growth of term lending....In many important respects, the bank term loan can be reviewed as an almost new way of employing money." The lack of authentic data[11] as to the maturity period of loans stands in the way of making a correct assessment as to the position of commercial banks in term financing in India. It can fairly be assumed that a substantial amount of the increasing volume of bank finance is in the nature of term loans.

Over the planned period, there has been a deepening as well as a widening of the industrial structure. Not only have the established industries increased their installed capacity and output but a wide range of new industries in the field of capital and producer goods which provide the foundation for a self-sustained growth of the economy have been set up.[12] In the context of the enlarged programme of industrial development in the Plans a reconsideration of the possibility of commercial banks in India contributing to term financing has again revived the issue. The slow progress of the special financial institutions convinced the men at the helm that

> ...what was really needed in the Indian situation was a more business like distributive machinery with a capacity to carry large loads of industrial finance to all corners of the country in response to the rapidly rising requirements.[13]

The institutional agencies that might be expected to cater to the medium-term needs of small and medium-sized industries are the State financial corporations now operating in all the States. The performance of some of the SFCs has not been satisfactory. The machinery of the SFCs, unfortunately, is slow-moving and it lacks local contacts. The possibility of direct local contact with industrial units scattered over a wide area thus appears to be slender. And this absence of local contact is a great handicap in scanning and assessing the application for loans.

Small and medium-sized industries find it difficult to secure adequate finance from the existing institutional sources even to meet their working capital requirements, least of all long-term loans. This is the result of their own inherent limitations on the one hand, and the generally high standards applied by the lending institution to borrowers on the other. The other difficulties are rigidity of approach on the part of the SFCs in dealing with the borrowers, the complicated nature of information required of them, strict requirements of security, rigid prescription of acceptable collateral and procedural delays involved in the sanction and disbursement of loans.

[10] Robinson, R. I., *The Management of Bank Funds*, McGraw-Hill Book Co., New York, 1962, pp. 245 and 247.

[11] Letter from the Reserve Bank of India, Bombay No ED. HD. 5230/B5. 0110, dated January 10, 1967, addressed to the author.

[12] *Third Five Year Plan* (summary), Government of India, Planning Commission, New Delhi, pp. 121-136.

[13] Gupta, L. C., "Role of Commercial Banks in Medium-term Industrial Financing", *Capital*, Annual Number, 1965.

The institutions which generally respond to a certain extent to the needs of this sector are the smaller banks whose resources are limited and, therefore, their field of activity is restricted to a small area. The bigger banks with larger resources and branch organisations would do well, in the interest of national economy, to take a promotional view in the initial stages and extend the much needed term credit to the small and medium-sized sectors. The most onerous responsibility devolves upon the Reserve Bank of India as the guardian of the money and capital market to persuade the larger banks to widen the range of their activities to cater to the needs of term finance of this sector of industry.

IV

Liquidity and Maturity Aspects

As observed earlier, so far as the trends in commercial banking theory and practice are concerned, one of the most important developments since the 1930s has been the extension of term loans for financing the medium and long-term capital and the credit needs of business. This development in banking practice is clearly a breach of the traditional theory of bank liquidity or the real bills doctrine. In view of the above changes in commercial banking theory and practice (Chapter 4) the traditional concept of liquidity requires to be modified and the banking authorities should reconsider the concept of 'sound assets'. The factor of nonliquidity in the matter of term financing can, to a large extent, be eliminated by a liberal approach of making advances by the Reserve Bank of India on the model of the United States Federal Reserve System.

The eligibility criteria under the refinance scheme should be further relaxed so that commercial banks can take more advantage of the refinancing facilities. This will help indirectly the process of capital accumulation as the proceeds of term loans are generally utilised for mainly 'capital purposes'. In other words, term loans are used for expansion of plant capacity, establishment of new industrial units, modernisation of productive processes by introducing rationalisation in the industrial structure. Term finance may also take the form of subscription to the equity capital of a corporate undertaking or to the debentures issued by it. Term loan, in a manner, stimulates industrial productivity and volume of return on the capital employed. The loan is intended to be repaid out of this profit. Hence, term loan implies, in a way, a process of self-liquidation of such loans and its liquidity is connected with the success of the borrowing units in the long run. Repayments will flow in smoothly only if the income of the borrower increases as anticipated. That is why the liquidity of term loans is said to depend on the theory of the 'anticipated income' of the borrower. Banks, today, make loans based on the projected income flow of the borrower. If income generation is assured and if funds are available, loans are granted. On the other hand, if the income flow does not appear to be assured, the loan is declined. Again, the liquidity of term loans ultimately rests on the stability of the economy. By the stability of the economy, we mean here, continued consumption by the public of the goods and services produced by the term

loan borrower. The acceptance of developmental planning in India has eliminated the possibility of serious economic fluctuations. A sudden and sharp decline in prices might impart a high degree of risk to a commercial transaction and impair the liquidity of a loan financing the transaction regardless of the maturity date of the credit. The level of bank deposits in a developing economy is expected to rise steadily. It can, therefore, be reasonably asserted without any fear of contradiction that liquidity is needed by the banking system only to take care of the normal ebb and flow of funds and to facilitate central banking control. In view of the above, term lending by commercial banks has been held to be compatible with the maintenance of reasonable liquidity.

It is well known that a substantial portion of Indian banks' short-term credit is 'rolled over'. In other words, short-term loans or overdrafts and cash credits once granted are repeatedly renewed or reloaned immediately. In effect, if not in form, this amounts to term lending. According to the Shroff Committee:[14] "Though this part of the finance revolves or rolls over, in actual effect it does serve the needs of providing finance for long periods to a certain extent". So, term credit in a disguised form is actually being extended by the Indian commercial banks without any adverse effect on their liquidity position.

An important aspect of term loans is that they are not as liquid as they are supposed to be. On the contrary, there is an element of a larger degree of liquidity when regular amortisation of term loans is provided for, rather than a false notion of the liquidity of short loans of revolving character. On the liquidity and maturity aspects of term loans, it is pertinent to quote Professor Robinson[15] again:

> The problem for the individual bank...is the overall distribution of maturities within its entire investment portfolio....If cash flow has been well estimated so that payments are made when due and few extensions are requested, a portfolio of term loans can offer an appreciable degree of liquidity,

Another important point that needs to be emphasised is that term finance disciplines both the banker and the borrower as long term planning is required to ensure that cash inflows will be adequate to meet the instalment repayments and allow an active turnover of the bank's loan portfolio.[16] The adoption of the method of formal term loan by at least the big banks, to begin with, would go a long way to help economic growth. This, however, calls for a flexibility of approach and catholicity of outlook on the part of the commercial banker as well as the central banker. The position of the central bank *vis-à-is* commercial banks has been carefully examined by Professor Sayers[17] when he observes:

> The upshot is that the central bank...should adopt no rigid rule against medium-term and long-term lending by the commercial banks. Even the smallest banks must lend for longer terms than would match their assets and the central bank must be prepared to supply additional liquidity in case of emergency.

[14] *Report of the Committee on Finance for the Private Sector*, Bombay, 1954, p. 45.

[15] Robinson, op. cit., p. 249.

[16] Reserve Bank of India, *Appraisal of Term Loans*, 1962, p. 9.

[17] Sayers, R. S., *Central Banking After Bagehot*, Oxford, 1957, pp. 121-122.

Here a passing reference to the Australian experiment in term loans will be useful in order to examine the Indian situation. In Australia, loans are made for fixed periods, usually 3-8 years, though the arrangements may be varied to cater for activities which are not initially income producing. The initial size of the term loan funds was equivalent to 3 per cent of each bank's deposits. In March 1966, following discussions between the Government, the Reserve Bank and the major trading banks, the introduction of new farm development loan facilities was announced. These facilities were designed to provide rural producers, particularly the small producers, with greater access to medium and long-term finance through the banking system. Loans under the arrangements were directed predominantly to developmental purposes which raise productivity. In examining applications for loans the banks were prepared, in appropriate cases, to relax normal security standards; they gave special consideration to the needs of creditworthy younger men with appropriate experience who had been unable to build up adequate resources. Each major trading bank established with the Reserve Bank a farm development loan fund account from which to make such loans. The aggregate amount initially transferred to these accounts was A$50 million, of which about two thirds was provided from the banks' statutory reserve deposit accounts and one third from the banks' liquid assets.[18] Funds provided by the trading banks in this way were in addition to those available on overdraft and from Term Loan Fund, and represent a net addition to bank lending in the rural sector.

The term-lending capacity of an Indian bank will, however, depend on its overall financial position. Various suggestions may be made to assess the strength and capacity of an individual bank in India to grant term finance. The structure of a bank's deposits, i.e. the size of its term deposits in relation to its total deposits, is a useful indicator to gauge the strength of a bank qualified to grant term finance. The capital-fund ratio, i.e. the ratio of paid-up capital and reserves to its total deposits and the general level of the advance-deposit ratio are also important indicators to assess the capacity of a bank for term financing.

The risk-bearing ability of banks is generally related to the size of their equity funds. To start with, a reasonable ceiling may be prescribed taking the financial position of the lending bank as a whole. A ceiling in terms of, say, a proportion of the owned resources (capital and reserves) or owned resources plus time liabilities may be prescribed to regulate the expansion of term lending.[19] It has been suggested that an investment of only 5 per cent of deposits in industrial securities would make available a considerable amount of term finance without affecting the liquidity position of the banks concerned.[20]

Many bankers apprehend that organisational problems are likely to stand in the way of such innovations. The American experience however indicates that though there were initial problems to be solved, it was not difficult for the

[18] *Commerce*, Annual Number, 1967.

[19] Madan, B. K., *Aspects of Economic Development and Policy*, Allied Publishers Pvt. Ltd., Bombay, p. 244.

[20] *The Committee on Finance for the Private Sector*, pp. 48-49.

banking system of that country to cope with the matter by building up funds of skill and talent in a short space of time. Likewise, the Indian banks with a wealth of experience of the economic situation in the country and a wish to play a pivotal role in the growth of the national economy can well rise to the occasion to come out of the conservative fold and give the required funds to enable the industries to forge ahead. Before long, the Indian banking system should be able to equip itself reasonably for this innovation in its operational behaviour. Hence the apprehension of organisational shortcomings cannot be taken as an insurmountable factor. What is actually needed is a conscious effort on the part of the central banking authority to welcome this operational innovation.

Lending is an art. It is difficult to lay down hard and fast rules regarding lending practices in general, and term financing in particular, as circumstances conditioning loan applications can never be uniform and, therefore, do not conform to set rules.

V

Commercial Bank vis-à-vis Development Banks: A New Approach Towards Functional Integration

Before we close our discussion on the *raison d'etre* of term finance by the commercial banking system, it would be pertinent to assess the functions of a commercial bank *vis a-vis* a development bank in providing industrial credit. The central bank of a country can bring about an even development of the economy by demarcating the coverage of the activities of both the commercial banks and the development banks.

The existing institutional agencies for the provision of term finance have frequently been operating in the same field with hardly any demarcation of their specific areas of activity with the result that an unhealthy competition exists between them and also an overlapping of functions. The multiplicity of financial institutions alone is, obviously, not enough to stimulate expansion in the absence of a coherent plan to coordinate investment. To avoid confusion and to distinguish the role of commercial banks in medium-term financing from long-term financing, it is necessary for the Reserve Bank of India, as well as the development banks themselves, to provide clear-cut definitions of the two and explain the distinctions between them. It must be clearly shown, for example, whether the difference between the medium-term and long-term rests merely on the periods of the loans or depends upon their nature and purpose. The period of loans cannot always be the sole deciding factor.

It is our opinion that there should be a well-defined and clearly demarcated sphere of activity where agencies like the IDBI must operate alone and from which commercial banks should be excluded. There is a large area for long-term lending to comparatively new concerns in which commercial banks' entry may be risky and therefore not desirable. Again for loans of long duration (above 10 years' maturity) and of a large size in relation to the other resources of the borrowing unit, commercial banks' entrance should not be permitted. But in

other types of credits especially in term loans repayable within a period of 10 years commercial banks will be able to play a helpful role. Why and how commercial banks should give up their old conservative policy and come forward with term finance in the changing economic horizon in the planned economy of India has already been discussed in detail.

The IDBI, would generally assist projects which involve more than ordinary risk financing, owing to absence of immediate profit yield or inadequate initial security, where commercial banks might not feel tempted to step in. Projects with a long gestation period should ordinarily be nurtured by development banks like the IDBI, etc. In its refinancing function, the IDBI eases the liquidity problem of banks by providing resources for the agreed term. It is not justified, therefore, to say that term lending by commercial banks affects the liquidity of the banking system.

The increasing needs of industrial projects for term finance, coupled with the acute shortage of resources available to the development banks, have caused great concern among the authorities and revived the issue of commercial banks' role in term finance since there are innumerable difficulties in obtaining larger resources by the development banks. The IDBI has complained of 'limited resources' and is constrained to adopt a 'selective approach'. The IFCI has also reported its difficulties and disappointment in obtaining larger finance to cope with rising financing operations. The Chairman of the IFCI publicly complained that the Corporation was unable to fulfil its role on account of insufficiency of resources. For the past few years, the ICICI too, has been living from hand to mouth. The development banks have all along depended for the bulk of their resources on the Government. The SFCs have frequently short of funds and have to place increasing reliance on institutional support for finance. They are in a bad way precisely because the State Governments do not provide them with resources. The Government which has fed these institutions with ample resources so far, is itself in a delicate financial position.

An analysis of the charter of development banks reveals that they are intended to supplement, rather than supplant, the existing sources of industrial finance, such as commercial banks and other market institutions. They attempt to provide assistance only to cases where alternative financing is not available under reasonable terms and conditions. The preamble of the Industrial Finance Corporation Act, 1948, specifically provides that the Corporation is established to provide term finance in circumstances where normal banking accommodation is inappropriate. Similarly, the object of the British Industrial and Commercial Finance Corporation Ltd. is to provide finance to industrial concerns where existing banking facilities are not easily available.[21] The British Finance Corporation of Industry Ltd. is mainly interested in those enterprises which have prospects of success but cannot be immediately financed through normal channels of banks etc.[22] The IDB Act, 1944-46 of Canada has made a provision that it can provide credit or other financial resources if such credit is not otherwise

[21] Basu, S. K., *Industrial Finance in India*, 2nd edn., University of Calcutta, 1950, p. 386.
[22] Ibid., p. 393.

available on reasonable terms and conditions.[23]

Broadly speaking, commercial banks and development banks must be allotted specific spheres of activity and there must be an integrated approach to the entire problem of industrial financing. However, rigid demarcation of the coverage of the activities for development banks and those of commercial banks would be inappropriate. It is suggested, therefore, that development banks in India should be directed to go in for long-term financing where risks are far greater but commensurate also with the profit yield. They would be well advised to undertake the risks involved in long-term financing for loans above 10 years' maturity. Again, it is recommended that projects with inadequate security and a long gestation period may be the domain of a development bank. In Turkey and New England, for example, the commercial banks often refer potential borrowers to the development bank or the development credit corporation when the borrowers' proposals are considered too risky for a normal commercial bank or involve too long a term.[24] The calculated risks of term loans upto 10 years based on adequate information, judgment and analysis should be borne by the commercial banks in the interest of planned economic development in India. By such a judicious balance of functions between the development banking sector and the commercial banking sector, an even development of the economy can be assured.

VI

Observations

With the sustained efforts for mobilising deposits to keep pace with the rapidly growing demand, the position in relation to bank deposits is likely to become easier. The spread between time deposits of short and long maturities has been further widened in recent years. The growth rate in time deposits, which picked up in 1973-74, accounted for the major proportion of the incremental deposits with 61.0 per cent share in the deposit accretion. There can, therefore, be no real objection on the grounds of banking theory to use a part of bank deposits for term lending under the changed economic climate and banking conditions of today. The growth in term funds enables the banks to take a greater share in the term needs of industry.[25]

The present conditions in India are especially favourable to the adoption of formal term lending, particularly by the larger banks. The tone and efficiency of the banking structure of the country has been greatly strengthened during the fifties by virtue of the passing of the Banking Regulation Act, the subsequent amendments thereto, and particularly after the introduction of the Deposit Insurance Scheme in 1962. The acceptance of economic planning has brought about greater stability and discipline in the economy. The Reserve Bank has

[23] Section 15(1)(b) of the Industrial Development Bank of Canada Act.

[24] Diamond, W., op. cit., p. 46.

[25] *Trend & Progress of Banking in India*, 1965, Reserve Bank of India, published in *Reserve Bank of India Bulletin*, May 1966, p. 540.

been vested with wide and sweeping powers to control and regulate banking activities. The nationalisation of the major banks is another forceful factor. The needs of industry in the planned period are such that loans for a longer duration than are generally granted by banks are required. The objections to capital or term lending should, therefore, break down under these changing circumstances.

In the USA, during the period 1946–55, term loans increased by 200 per-cent approximately for relatively small borrowers and 87 per cent for large business concerns. This was the period of rapid expansion when business needed funds for plant expansion, the purchase of equipment, etc.[26] The present Indian economy under the stimulus of the Five Year Plans has been passing through a similar period of new business formations, growth, and expansions accompanied by an increase in term loans. In other words, growth in term finance aids the process of capital formation and economic expansion. The Indian banks have, therefore, to focus attention on the task of a scientific examination of term loan applications making use of criteria adopted in other countries to the extent permitted in the Indian context.

The traditional method of assessing the capability of industrial borrowers should be avoided and a breadth of vision will be required to judge the capacity of an industry insofar as repayment of loans is concerned, not on the basis of the extent of ownership of assets but on the capacity of future yield on which alone depends the safeguard of the banking system against the calculated risk of term loans. The wisdom of allowing term loans will no doubt hinge on the ability of the banker to distinguish between an industry's economic possibilities and an industry with an immediate rosy picture offering no certainty as to its sustain-ability in future. In this regard it is pertinent to quote the following observa-tions:[27]

> While a static analysis of the balance sheet position would suffice for short-term loans, appraisal of term loans requires a dynamic approach, involving as it does, among others, a projection of future trends of output and sales and estimates of costs, returns and flow of funds.

Thus, from the standpoint of loan liquidation, 'anticipated income' has sup-planted the 'self-liquidating' theory of repayment that has characterised short-term loans.

It would be a good augury on the part of the central banking authority to provide active encouragement to small and medium bankers also to adopt this line. Those small and medium-sized banks which cannot afford to maintain technical staff individually could join together and set up a common advisory board, or they could form a consortium on the German model which would also distribute the risk among the bankers.

Even the Radcliffe Committee which met exactly three decades after the Macmillan Committee, has recommended that the banks should be ready to grant term loan facilities within individual limits as an alternative to running

[26] Reed, op. cit., pp. 306–307.

[27] *Appraisal of Term Loans*, Reserve Bank of India, Bombay, 1962, p. 11.

overdrafts for creditworthy commercial and industrial customers. Further it has been discovered by experienced bankers that term credit correctly granted, supervised, and in proper amounts is a desirable form of earning assets.

It is time for the Reserve Bank of India too to revise its conservative policy regarding term financing by the commercial banking system and take bold measures to tackle the situation threatening industrial development. A more imaginative outlook, a versatile approach free from the old shackles of conservatism which cramped their operations in earlier years, and the commercial banks can certainly take up the challenge thrown by the rapidly changing economic scene. Finally, the central banker as lender of last resort is duty-bound to support the market, 'with adequate loans to relieve a liquidity crisis', but he has 'no duty to support everybody alike'. The central bank, in the words of Professor Sayers,[28]

> will channel its help only through institutions that have conducted their business on healthy lines. This is a powerful sanction, and the central bank should make the most of it in order to guide and encourage the growth of healthy commercial...banks to meet the needs of the expanding economy.

[28] Sayers, R. S., op. cit., p. 121.

9

Central Bank in Relation to Development Bank

Central Bank as a Development Agency

Central bank participation in the establishment and management of development banks is fairly common. The growth and efficient working of all types of financial institutions is the concern and responsibility of a central bank. In fact, central banks (including the archetype of all central banks, the Bank of England) have generally played an important role in the establishment and working of development banks. This is only proper on account of the central bank's pivotal position in the money and capital markets. In fact, the role of a central bank in underdeveloped economies will be quite varied and extensive. As a development agency, a central bank has a strategic part to play in the economic development of these countries, particularly in the long run. An important facet of this role is the building up of the 'financial infrastructure' of future economic development. It has to adopt ways and means for quickening the development of a diversified institutional framework corresponding in nature to social overhead capital like transport and power. The chief elements of this role consist in creating local money and capital markets where these are nonexistent, in further developing and strengthening these markets where they exist only in a rudimentary stage, in promoting the growth of various types of financial intermediaries with their diversified financial assets and thereby facilitating the process of saving and investment, and in establishing an expert intelligence service with a view to seeking out and highlighting the crucial variables in the economic system. Apart from the central bank's role in building up an institutional and financial framework conducive to economic development, it has a magnificent part to play in financing the economic development in underdeveloped countries, directly as well as indirectly. When we speak of the central bank as taking a direct part in financing economic development we do not suggest that it should get involved in the appraisal or administration of industrial and agricultural loans. It does not possess the necessary expertise for the management of such loans or the requisite machinery for screening the

various proposals that may be put before it. The central bank's proper role in this regard is to promote the establishment of specialised financial institutions such as development banks by participating in their equities and bonds, by making loans and advances to the institutions, as the need arises, and sometimes even by owning them wholly. There are, again, various ways in which the central bank can take a share in the indirect financing of the country's economic development. It can, for example, extend its guarantee to the payment of a minimum rate of dividend on the share capital of the development banks and the principal and interest of the bonds issued by them, as well as to the loans granted to them by foreign institutions like the World Bank and its affiliates. It can make available its expert technical advice to the development banks with regard to the timing of their bond issues. The central bank is also rather favourably placed to resist political and sectional pressures. Nomination of directors, the loan of the services of its officers, who would occupy managerial positions in the development banks, or help hire such officers are also other ways in which a central bank can help the development banks. Generally, there are also arrangements for the central bank to make short-term as well as medium-term advances to development banks up to specified limits.

In the advanced economies specialist institutions for meeting the various types of financial requirements have gradually evolved in the normal course of time and have attained maturity only after passing through the various stages of growth and experiment. The building up of such institutions cannot be left to the process of evolution in the underdeveloped countries. The evolutionary process will inevitably be slow, too slow, to fulfil urgent needs. Agriculture and industry in these underdeveloped economies are badly in need of capital, both loan and equity, as well as proper technical advice and guidance without which their development cannot be accelerated. The promotion of such specialist institutions by the central bank is, therefore, an important desideratum for quick economic growth. The wide range of specialised banking and other financial services to be seen in the industrially advanced countries today does not exist in the underdeveloped countries or exists only in a rudimentary stage. An agency will be required to create and foster them. The most appropriate agency for the task is the central bank.

In the advanced countries the central bank had a base for its operations in the variety of financial intermediaries already in existence. In the underdeveloped economies and emerging countries of Africa the usual pattern is reversed; and it is the central bank itself which will have to sponsor and develop the institutions which will ultimately become the necessary base for its operations. The central banks in those countries have in actual practice participated in the direct and indirect financing of their economic development by assisting the formation of development banks through equity participation either wholly or partly, by providing marginal assistance to the long-term lending institutions and by guaranteeing their obligations in the domestic as well as the overseas market. Central banks in such countries thus have to perform a very significant role in assisting the institutionalisation of savings and investment. The rate of economic growth is conditioned by the accumulation, disposition and diversification of

financial assets. Such accumulation of financial assets with a diversified pattern of risk and reward attaching to them ensures a wider and more rational choice for savers. It also provides a more efficient mechanism for the allocation of investable resources through the operation of financial intermediaries in their various forms which tend to grow with the increasing tempo of economic development. It may be pointed out here that most of the central banks operating in the newly independent African colonies have been fulfilling an important role in creating and developing a variety of financial intermediaries extending short, medium as well as long-term credit.[1]

It is in this context that reference must be made to the institutional device—development banks—in the sphere of industry and agriculture which has come to be adopted by many underdeveloped countries to attain a rapid rate of economic development. Designed to provide the most fundamental ingredients of economic development such as capital, enterprise, technical know-how, etc., they have come to be established in the various underdeveloped countries not only of Latin America but also those of Asia and Africa. Specialist institutions for providing development finance are to be seen in advanced countries where they also cope with specific problems posed by the after effects of the Wars, the Great Depression and widespread unemployment. In some cases they have been totally Government-owned; in others partly Government and partly central bank-owned and in yet others privately owned or even mixed. There are one or two remarkable instances of development banks being completely owned by central banks such as the Industrial Development Banks of Canada and India. The recently established Industrial Development Bank of Nepal is public-owned. In the case of the Napalese Industrial Development Corporation, the Act has no doubt provided for private investment but the shares are at present owned by His Majesty's Government of Nepal. The Development Bank of Indonesia (1960) is completely state-owned. Whatever may be the structure of ownership of the banks, they have almost invariably been sponsored by the Governments or the central banks or in conjunction with both. In almost all countries, whether developed or underdeveloped, wherever development financing institutions have been set up, it is the central banks which have assisted in their formation by participating wholly or partly in their share capital, by refinancing their loans, and by guaranteeing their obligations in the internal as well as the international capital market.[2]

Thus central banks, in developing Asian countries like India, Pakistan, Ceylon, Nepal, etc., as well as in the developed countries such as the UK and Canada in the West, have been instrumental in promoting the establishment of a network of development banks by directly subscribing to their initial capital

[1] Deshmukh, C. D., "The Balance Between Monetary Policy and other Instruments of Economic Policy in a Modern Society", under the sponsorship of *The Per Jacobsson Foundation*, October 1, 1965.

[2] (i) Boskey, Shirley, *Problems and Practices of Development Banks*, Appendix D, "Sample Charters", pp. 146-188.

(ii) Diamond, William, *Development Banks*, Appendix II, pp. 95-118.

(iii) Basu, S. K., *Theory and Practice of Development Banking*, "Sample Provisions", pp. 156-229.

and in various other ways. The Reserve Bank of India has played a major role in promoting the institutionalisation of industrial and agricultural credit and building up a sound structure of development banking. In the African countries[3] development banks or corporations are already operating in Nigeria, Ghana, Sudan, Morocco, Tunisia, Libya and Rhodesia. The anxiety of the countries to participate in the promotion of various kinds of financial institutions for facilitating their economic development is reflected in the statutes of the central banks. The observations of Dr. Basu[4] in this regard are quite pertinent:

> The Central Bank as the central arch of the monetary banking structure of a country and being at the helm of financial management is the most suitable agency for broadening and deepening the institutional framework of development finance for promoting the country's economic development.

II

An Identical Board for the Central Bank and Development Bank: Raison d'etre of a New Development Bank

On the analogy of the Canadian IDB, the Board of Directors of the Reserve Bank of India is the ex-officio board of directors of the Indian IDB too. The tasks of a development bank are entirely different and the same Board cannot be expected to do full justice to different tasks at the same time. The Canadian bank has not been assigned the same ambitious role as the IDBI and the problems of development in the two countries are widely different. What may be sauce for the developed goose may not prove suitable for the undeveloped gander. On account of the marked widening of its activities, the central bank management may not be able to do justice to central banking responsibilities proper as well as to running a development bank. An identical Board for the central bank, and the development bank is, therefore, neither appropriate nor logical.

The IDBI was born out of the varying concepts of the functions and activities of development banks underlying the formation of all these institutions. A close examination of the statute establishing the Industrial Development Bank of India will at once make it clear that it is an amalgam of the ideas that were incorporated in the IFCI, ICIC, SFCs, NIDC and the RCI. The various forms in which financial assistance is provided by it closely resemble those of the IFCI and the the ICIC. Its field of activity is not confined to public limited industrial companies only like the IFCI and ICIC but extends generally to all industrial enterprises incorporated under the Companies Act or any other law, such as partnerships or private limited companies as in the SFCs. It covers not only all the various types of industrial enterprises and services which are within the purview of the IFCI, viz. those engaged or to be engaged in the manufacture, preservation or processing of goods, in shipping, in mining, in the hotel industry,

[3] Basu, S. K., *Central Banking in Emerging Countries*, Asia Publishing House, Bombay, 1968, pp. 200-233.

[4] Basu, S. K., *Theory and Practice of Development Banking*, Asia Publishing House, Bombay, 1965, p. 92.

in the generation or distribution of electricity or any other form of power, but also many other services like the transport of passengers or goods by road, water, or air. It is interested not simply in the private sector but also like the NIDC in the public sector and in the basic or key industries as well. Its activities accent not only the financing but also the development and promotion of industries, again like the NIDC, by providing technical advice and planning, promoting and developing industries. Lastly, the refinancing concept has been borrowed from the RCI in that it refinances the loans and advances granted to any industrial concern by corporations and institutions notified by the central Government in this behalf. It is also reminiscent of the Agricultural Refinance Corporation formed earlier under the auspices of the Reserve Bank of India with the object of providing long and medium-term refinance or finance facilities for development of agriculture and plantations (Chapter 6). Thus it is a mixture of various ingredients.

A more fruitful step would have been to unite the NIDC with its accent on promotion and development and the IFCI with its emphasis on financing.

> Instead of sponsoring another innovation and asking the Reserving Bank to adopt it as a child of its own, the Reserve Bank of India should have been better directed to act as a midwife to assist the birth of the IDBI out of the union of the IFC with NIDC.[5]

The proliferation of these institutions is puzzling and reflects the persistent efforts of the Reserve Bank to rectify the failures of its previous half-hearted attempts.

III

Central Bank as a Coordinating Agency

An important function that a central bank can perform in respect of development bank is to serve as a coordinating agency. In many countries, there are several development banks and the central bank is well placed to coordinate their policies and operations regardless of whether it owns any stock in them. In India, for many years now, the Reserve Bank has convened an annual conference of the development banks, which is attended by representatives of the development banks, as well as by representatives of the Government and some leading commercial banks active in term financing. The exchange of information and the frank discussion among representatives, under the Reserve Bank's guidance, have been of considerable assistance to the institutions.

Where there are several long-term financial agencies, there will be problems in the demarcation of spheres and of coordination. Where, for instance, separate development banks exist for large, medium and small industrial units, some overlapping will occur and working rules will have to be established for keeping this to the minimum. Where the statute sets the upper limit to the assistance that can be rendered to any single unit—Rs 20 lakhs in the case of the State

[5] Basu, S. K., *Theory and Practice of Development Banking*, op. cit., Chapters 9, 10 & 11.

Financial Corporations in India—such overlapping is avoided. Further, there is also an understanding that the Industrial Finance Corporation of India will not normally entertain applications for loans below Rs 20 lakhs.

These days there is a demand for funds in excess of availability. Coordination is mostly called for to allocate equitably the available funds among the numerous applicants. Coordination is of two types, that with regard to general operational policies and the other with regard to individual projects seeking assistance, especially the large sized ones. In respect of the latter, formal or informal consortia are often formed sometimes including commercial banks too. Consultations among the institutions are also called for while disbursing funds and while carrying out postsanction surveillance.

Coordination of the operations of not only the development banks proper, but also of other major financial institutions in the capital market, such as life insurance companies or corporations, provident or pension funds and other institutional investors is necessary. In many of the developing countries, such institutions are nationalised, their operations being subject to broad statutory control. This tends to secure, to some extent, the basic objective of coordination —the investment of funds in a manner that will promote the ends of the national development plans or programmes.

Finally, it may be observed that the arrangement relating to the nomination of the officers of the Government, the central bank, and the apex development bank on the boards of other development banks and institutional investors, ensures the presence of some common directors and helps in establishing a close working relationship among the development banks. However, it is undesirable to have such arrangements on an extensive scale.

IV

Observations

A development bank is an institution to promote and finance enterprises. It is intended to speed up economic development by making capital available and encouraging a spirit of enterprise. Perhaps the most important deficiency in India is not only finance but enterprise and managerial and technical skill too. What the business community in India, or in any other underdeveloped economy, lacks and what development bank can help provide are:

> the attitudes and skills required to direct private savings into productive enterprises no less profitable in the long run than the traditional uses of savings and much more important to rapid development.[6]

Thus, in the provision of long-term capital and stimulating enterprise, a central bank can have a substantial and beneficial influence on the economic development of a country by providing leadership and initiative in the establishment of development banks for specific fields.

Since the phenomenon of a central bank having a development bank as a

[6] Diamond, W., op. cit., p. 85.

subsidiary is very rare, it may be presumed that it is justified by special circumstances. In this connection it may be recalled that the Canadian Royal Commission on Banking and Finance, which reviewed the matter in 1964, concluded in favour of the existing arrangement of the development bank as a subsidiary of the central bank.

In an undeveloped money and capital market as in India today, it is wrong to insist categorically that a central bank should not undertake development banking. On the contrary, it should not hesitate to enter the field of development banking in the interest of stimulating the capital market, should it be necessary. Though India is progressing in economic development, the time has not yet come for the Reserve Bank of India to retreat from other than those pertaining to central banking functions. In fact, in a developing economy, the promotional role that a central bank has to play undoubtedly involves the assumption of diverse functions and the use of a multiplicity of techniques. Contrary to the present climate of opinion, the Reserve Bank of India is certainly not overstepping its role. In a developing economy, a central bank has to fulfil an important role in the financing of economic development and it does so by assisting the establishment of development banks.

The central banking institution, being at the helm of financial management, is the most suitable agency for broadening and deepening the institutional framework of development finance for stimulating the growth of the economy. The pursuit of developmental monetary policy, indeed, reinforces and strengthens the regulatory role of the central bank as these functions are complementary.

A central banker in a planned economy would fail in his duty if he concerned himself only with the negative regulation of the flow of funds. He would have to take an equally active part in creating, or helping to create the machinery needed for financing developmental activities in the desired directions.

10

The Reserve Bank and Export Credit Problems of India

Export Promotion and Economic Growth

Expansion of exports is the basic element in a strategy for financial recovery. Exchange of exports for imports leads to higher income which leads to higher savings which, in turn, make possible a higher level of investment.

An economy with a high growth rate is also expected to have a high export growth, and the latter plays an important role in industrial development. In fact, the growth potential of Japan's exports must be considered as an important instrument for her striking economic advancement. The Chancellor of the British Exchequer, also, in a statement stressed "export-led growth" for the financial recovery of the UK. Therefore, export industries in India must be given a higher degree of priority than has been the case so far. The pattern of investment should be more carefully and scientifically determined, in terms of cost-benefit ratio including the impact on foreign exchange.

In spite of an increase in exports India's balance of payments deficit went up to more than Rs 1,000 crores during 1974–75. According to the apprehension expressed by the World Bank the gap is likely to widen further in the current year. The strategic role of exports in stimulating economic development naturally leads us to consider the role of the Reserve Bank of India in promoting export trade. The achievement of the target for exports in the Fifth Plan will require determined and well-articulated export promotion efforts on the part of the Reserve Bank as well as the other banks engaged in financing foreign trade.

Export finance means the provision of funds to facilitate the carrying of commodities from the point of manufacture to the point of delivery. It stands for larger and cheaper credit facilities to the exporters. Extension of credit to Indian exporters ultimately results in more favourable terms to the overseas buyers. It is only the better payment terms that account for the capturing of the textile trade in Asian countries by China or the East European countries. The provision of adequate export credit at lower cost has assumed, undoubtedly, new significance in the development of international trade today. Indeed, the

leading exporting countries are providing larger and cheaper credit facilities, they have already established the necessary institutional financial arrangements and are striving to improve them further.

II

Mechanism of Export Trade Financing in India

Export finance in India may broadly be classified as preshipment or packing credits and postshipment credits. Preshipment credit connotes funds for facilitating production, processing or packing of exportable goods and finally arranging for their shipment. Packing credits, therefore, are intended to provide preshipment finance to the exporter to enable him to purchase the goods, process them if necessary. and ship them eventually according to the terms of his contract with the overseas buyer. This category of finance is assuming larger importance and greater significance in India in the present context as an all out effort is being made to stimulate exports. No exact statistical data is available to distinguish preshipment finance from domestic trade credit, inasmuch as many goods are produced both for export and for consumption in the home market. Nevertheless, it is true that bank credit has a positive role at the preshipment stage of foreign trade. This credit is, generally, in the nature of short-term advances and partakes of the form of cash credit or overdraft from banks. Sometimes credit opened by foreign banks on behalf of overseas importers in favour of Indian exports contains a red clause. This clause indicates the buyer's reliance on the seller's honouring the obligation under contract so as to induce him to arrange for advance payment prior to the shipment of the goods. It authorises the negotiating banker to grant an initial advance to the beneficiary to enable him to pursue the operation leading to the export in question. This practice has not gained ground in India yet.

In Australia, the short-term financial requirements of primary producers are met by the Reserve Bank of Australia through its Rural Credits Department. This Department finances the statutory Marketing Boards to enable them to make payments to growers for the primary produce pending its sale in the local market or abroad and also to finance marketing expenses which, in some cases, include processing and packing of the commodity. The maximum period for repayment of the advance is one year which is adequate for the purposes of export of primary produce. The bulk of the export finance, both preshipment and postshipment, is provided by trading banks which are specially instructed to bring to the notice of the Reserve Bank of Australia any stifling of foreign trade owing to the restrictive credit policy of the Reserve Bank that it may consider relaxing it in such an exigency. With regard to the cost of export finance at the preshipment stage, the banks are requested to charge special low rates for export industries irrespective of whether a part of their production is for domestic production or not.

Another form of preshipment finance in vogue in Australia is termed 'back to back' credit. In the export-oriented programme of India's planning, this

type of credit can play a useful role in facilitating exports. It often happens that the Indian exporter does not have enough finance to pay for the goods he proposes to ship abroad. In this case, he can request his banker to establish credit against an overseas letter of credit.

III

Existing Export Credit Arrangements and the Need for an Export-Import Bank

Three major aspects of export credit are the availability and cost of credit, insurance of risks and guaranteeing of export credit, and a system of collecting information on foreign markets and creditworthiness of importers, etc. The institutions which provide export credit in India, either directly or through refinance, at present are: (i) commercial banks, (ii) the Industrial Development Bank of India, and (iii) the Reserve Bank of India. Commercial banks provide short-term as well as long-term credit to exporters at both the preshipment and the postshipment stages. The quantum of finance provided by commercial banks to the export sector has shown a steady progress from Rs 263 crores in June 1969 to Rs 382 crores in June 1971. As a proportion of total credit, it has gone up from 7.3 to about 8 per cent. Commercial banks have also relaxed their procedures in respect of such credit.

The Reserve Bank and the Industrial Development Bank of India supplement the resources of commercial banks. The former refinances scheduled banks in respect of their short-term credit not exceeding 180 days. The basic object of the Reserve Bank's policy has been to insulate the export sector from the impact of its policy to restrict domestic credit.

The history of its policy on export credit has been one of liberalising refinance facilities to commercial banks. Since 1968 concessional rates of interest have been fixed for export credit by banks. To compensate the banks for the difference between this rate and the rate they would normally have obtained, the Government of India pays them a subsidy at the rate of 1.5 per cent per annum on their outstanding amount of export credit. Refinance of export credit is made on concessional terms and borrowings by scheduled commercial banks for the purpose are not taken into account in calculating the net liquidity ratio. Export credit given by banks is exempted from the 'norms' relating to insecured advances and guarantees given by banks to exporters. The IDBI supplements the resources of commercial banks both by way of refinance and participation loans in respect of medium-term advances. Refinance is provided at concessional rates. With the increasing importance of term credit, the IDBI introduced a scheme in December 1968, in participation with approved commercial banks, for providing direct term finance at a low rate of interest and guarantee facilities to industrial concerns for the export of engineering goods or services on a deferred payment basis.

As for the cost of credit, the maximum rate which scheduled commercial banks can at present charge on their preshipment and postshipment credit,

other than the credit provided to exporters on deferred payment basis, cannot exceed 11.5 per cent. The maximum rate on deferred payment export credit is 8 per cent. It will thus be seen that, from the point of view of availability and cost of credit, the present institutional arrangements will not be improved by the creation of a specialised institution like the Export and Import Bank.

It is sometimes contended that if a specialised export-import bank is set up, it can take care of all the export credit problems of an exporter so that he does not have to go from one institution to another, for example, to a commercial bank for obtaining a loan, to the Export Credit Guarantee Corporation (ECGC) for export credit guarantee and to the IDBI in the case of participation loan arrangements. The Banking Commission also feels that it is not necessary to create a new institution for coordinating the efforts of different institutions. Consultative and informal groups constituted by the IDBI can be entrusted with this function.

The Indian money market and capital market has already been flooded with a plethora of specialised institutions for specific fields of economic activity. The logic of the creation of a new institution for coordinating the efforts of another coordinating agency—the IDBI—and others is, indeed, puerile.

So far as the question of providing insurance or the guarantee cover for export loans is concerned, the ECGC has progressively liberalised and extended the coverage of its schemes. The following Table shows the value of bank advances and other facilities obtained by exporters under the fold of ECGC's guarantees from 1966–74:

Year	*Value covered (Rupees in crores)*	*Percentage increase over the previous year*
1966	39.17	—
1967	66.16	68.0
1968	108.79	64.4
1969	166.52	55.1
1970	207.93	24.9
1971	289.73	39.3
1972	506.35	78.8
1973	973.31	92.2
1974	1,335.35	37.5

The policies of the ECGC are beneficial both to the exporters and to the banks. It is not, therefore, clear how the creation of a specialised institution will improve the guarantee facilities. There is however one lacuna—the absence of insurance against the risk of variations in the rates of foreign exchange. The Reserve Bank should make suitable arrangements for providing exchange cover on reasonable terms in respect of exports made on a long-term deferred payment basis.

Regarding the pooling of information relevant from the point of view of exporters, the IDBI is in an excellent position to obtain the information, keep it up-to-date and make it available to commercial banks and others. Hence, on this ground also there is no need for creating an Export Import Bank.

The Reserve Bank of India recently announced additional incentives to the export sector in view of international developments. In modification of its directive governing its export credit policy the Reserve Bank has provided some relief in preshipment and packing credit for specified medium and heavy engineering goods as well as for construction contracts. The salient features of the recently announced policy providing additional incentives to the export sector are given below:

(i) On preshipment credits in general the maximum period for which the concessional rate of interest at 11.5 per cent per annum applies, will continue to be 90 days. In case preshipment credit has to be given by banks for a longer period, on account of delays attributable to reasons which are beyond the control of the exporter, banks are required not to charge a rate exceeding 2.0 per cent over the concessional rate of 11.5 per cent (i.e. 13.5 per cent) for a further period of up to 45 days.

(ii) In the case of preshipment credit for specified medium and heavy engineering goods, the period for which the concessional rate of interest at 11.5 per cent per annum applies will be raised from 90 days to 180 days. In case preshipment credit has to be given by banks for a longer period, on account of delays attributable to reasons which are beyond the control of the exporter, banks are required not to charge a rate exceeding 2.0 per cent over the ceiling rate of 11.5 per cent (13.5 per cent) for a further period of up to 90 days.

(iii) Over and above these periods stipulated according to the two-tier system, banks are free to charge normal lending rates in respect of items (i) and (ii) above[1] (for further details see Chapter 2).

IV

Refinance Facilities to the Scheduled Commercial Banks from the Reserve Bank of India

An outline of refinance facilities to the scheduled commercial banks from the Reserve Bank of India is given in the accompanying charts.

Export credit has been accorded special status in view of the need for intensifying export promotion. Even so, an element of discretion in sanctioning refinance accommodation to commercial banks against their preshipment (packing credit) and postshipment credit was introduced in the wake of credit control measures initiated by the Reserve Bank in November 1973. Refinance up to 10 per cent of the weekly average of an individual bank's export credit (preshipment and postshipment) was granted at the Bank rate up to the end of June 1974; borrowings under this limit, however, impaired the bank's net liquidity ratio. Additional refinance was provided in deserving cases by the Reserve Bank for meeting exclusively the credit needs of the export sector at net liquidity ratio. In July 1974, the Reserve Bank withdrew the export refinance limits

[1] BDOD. No. Dir. BC/38/C. 96-75, dated May 8, 1975.

Refinance Facilities to the Scheduled Commercial Banks from the Reserve Bank of India

(1) *Effective from Nov. 1, 1971 to Nov. 16, 1972*

Net Liquidity Position (1)	*At 4.5 per cent* (2)	*At Bank Rate (6 per cent)* (3)	*Remarks* (4)
		1. Export Credit:	
Irrespective of net liquidity ratio.	Up to an amount equal to 10% of the annual average in 1971.	An additional amount of 10% of the annual average in 1971.	Borrowings equal to 20% of the annual average of export credit in 1971 will not impair the net liquidity ratio. 1971 base to be effective from Jan. 1, 1972.

(2) *Effective from Nov. 17, 1972 to Mar. 29, 1973*

Net Liquidity Position (1)	*At 4.5 per cent* (2)	*At Bank Rate (6 per cent)* (3)	*Remarks* (4)
		1. Export Credit:	
Irrespective of net liquidity ratio.	Up to an amount equal to 10% of the annual average in 1972.	An additional amount of 10% of the annual average in 1972.	Borrowings equal to 20% of the annual average of export credit in 1972 will not impair the net liquidity ratio. 1972 base to be effective from Jan. 1, 1973.

(3) *Effective from Mar. 30, 1973 to June 12, 1973*

Net Liquidity Position (1)	*At 4.5 per cent* (2)	*At Bank rate (6 per cent) up to May 30, 1973, and 7 per cent thereafter* (3)	*Remarks* (4)
		1. Export credit:	
Irrespective of net liquidity ratio.	Up to an amount equal to 10% of the annual average in 1972.	An additional amount of 10% of the annual average in 1972.	Borrowings equal to 20% of the annual average of export credit in 1972 will not impair the net liquidity ratio. 1972 base to be effective from Jan. 1, 1973.

(4) *Effective from June 13, 1973 to July 12, 1973*

Net Liquidity Position (1)	*At 5 per cent* (2)	*At 5.5 per cent* (3)	*At Bank Rate (7 per cent)* (4)	*Remarks* (5)
	1. Export Credit:			
Irrespective of net liquidity ratio.	Up to an amount equal to 10% of the annual average in 1972.		An additional amount of 10% of the annual average in 1972.	Borrowings equal to 20% of the annual average of export credit in 1972 will not impair the net liquidity ratio. 1972 base to be effective from Jan. 1, 1973.

(5) *Effective from July 13, 1973*

Net Liquidity Position (1)	*At Bank rate (7 per cent)* (2)	*Remarks* (3)
Irrespective of net liquidity ratio.	An amount equal to 10% of the annual average in 1972.	Such borrowings will impair the net liquidity ratio. If a bank has already borrowed under Section 17(3A) and such outstandings continue beyond July 12, 1973, they will also impair the bank's net liquidity ratio. 1972 base to be effective from Jan. 1, 1973.

earlier sanctioned to banks, whenever necessary, and charged a rate of interest of 10 per cent per annum in respect of limits allowed to continue for exceptional considerations. Further, in the wake of the increase in the ceiling rate of interest on export credit from 9 to 10.5 per cent per annum (with interest rate subsidy of 1.5 per cent per annum) to be charged by commercial banks effective from July 23, 1974, the refinance rate on export credit has also been increased to 11.5 per cent per annum; the earlier stipulation that borrowings under these refinance limits will impair the banks' net liquidity ratio continues. Considerable flexibility has been given to banks in respect of the security against which they can obtain refinance from the Reserve Bank. They need not necessarily borrow against Government securities but can borrow against a declaration of export bills and preshipment loans or advances under Section 17(3A) of the Reserve Bank of India Act, without encumbering their investments in Government and other approved securities.

It is well known that several small exporters are either not aware of, or have not fully understood, the implications of the schemes of the preferential treatment to export financing. Perhaps the Reserve Bank of India should bring out leaflets or brochures to popularise its schemes, both among the local exporters and foreign importers. It would be advisable to bring out explanatory leaflets giving concrete examples as guides to the bankers in their day to day

administration of schemes and thus enable them to cooperate fully with the policy of the central bank. In this context, the Japanese experience is of special interest to us. The rapid progress of the scheme of the Export Advance Bill system of the Bank of Japan (which is equivalent to the packing credit advances of the Reserve Bank of India) since its introduction in 1949, measured by the increased extension of the credit advance by the commercial banks under the scheme and financing at the Bank of Japan, has been particularly significant in the past few years. For example, the ratio of the Bank of Japan's monthly refinance to the total monthly exports was 9 per cent in 1960, shot up to 20 per cent in 1967 side by side with a significant rise in the monthly level of exports.[2] This is not only because of a further liberalisation of the scheme itself and simplification of the procedures undertaken by the Bank of Japan during the last several years, but also because of the Bank's sustained efforts at popularisation of the schemes through various media.

Under the packing credit scheme, the limits of refinance from the Reserve Bank have to be determined well in advance. Initially the central office of the Reserve Bank of India in Bombay is to be furnished with particulars of each exporter, to enable it to grant approval for the limits. Subsequently, central office approval is to be obtained also for enhancement of limits to approved parties, besides that for sanctioning fresh limits to new parties. The delay in processing applications is noticeable specially in the case of those from regional branch offices which are, at present, not empowered to sanction the limits but are only required to process the applications and forward them to the central office with reports giving a critical appraisal. It should be recognised that there is a danger of some exporters losing their export contracts because of the time lag involved in the processing and sanction of limits. Therefore, it is suggested that once a policy is laid down, the scrutiny of applications and the power of sanctioning of limits should be delegated to the regional branch offices. The examination by the central office could be done *ex-post-facto* for purposes of evaluating the scheme on a national basis. It is our understanding that by amending the Reserve Bank of India Act, the Reserve Bank's limit for respective exporters could be dispensed with and an overall limit fixed for each bank. This would enable the commercial banks to expand their packing credit advances to exporters more liberally. In other words, each commercial bank would be able to extend packing credit advances to respective customers fairly freely within the limit fixed for the bank, relying on refinance from the Reserve Bank of India. It may be observed that the treatment by the Reserve Bank of India of the lending limit would be almost the same as that of the postshipment credit of which few complaints are heard.

At present, bankers are required to observe certain norms with regard to their credit-deposit ratio—this is only a guideline and not a regulation. Most foreign banks and some Indian banks suggest that packing credit advances extended by them should be exempted for purposes of computing the credit-deposit ratio. In computing the net liquidity ratio, the commercial banks' increase

[2] *Reserve Bank of India Bulletin*, February 1969.

in borrowings over a base period concerning the packing credit advances and postshipment advances are not treated as a borrowing from the Reserve Bank of India and, therefore, the net liquidity ratio would not change even if commercial banks increase their borrowings for export financing. If similar preferential treatment could be introduced for the credit-deposit ratio, it would give a further inducement to the commercial banks for their lendings to the priority sector.

It is worth mentioning here that, judging from the 'balance of powers' between exporters and commercial banks, it may be necessary for the Reserve Bank to step in to give appropriate advice to commercial bankers. Periodic consultations between the officials of the Reserve Bank of India, exporters, and commercial bankers at the leading exporting centres would help focus attention on this and make possible a speedy solution of the problems arising from time to time.

V

Refinance for Medium-term Export Financing by the Industrial Development Bank of India[8]

The IDBI provides refinance to the eligible banks against medium-term export credits granted by them to exporters of capital and other engineering goods (including manufacturers, recognised export houses or other exporters of standing) in the private and public sectors. Till recently, a uniform interest rate of 4.5 per cent per annum was charged by the IDBI and the financing institutions were required not to charge the exporters more than 6 per cent per annum. Consequent on the Reserve Bank of India raising the ceiling on interest rates chargeable by scheduled commercial banks on their postshipment credits for exports on deferred payment terms, the IDBI raised its rate of interest on refinance assistance from the aforesaid 4.5 per cent to 5.5 per cent per annum with effect from April 30, 1974. The borrowing banks can now charge a maximum rate of 7 per cent per annum on their credit to the exporters (the rates have been raised by a further 1 per cent effective October 1, 1974, see Annexure at the end of the chapter). Till recently, the scheme stipulated that for export credits to be eligible, they should be repayable on the expiry of not less than 6 months and not more than 10 years. Since keen international competition has forced Indian exporters also to offer long credit periods for the export of capital goods, it was felt that in suitable cases export credits extended for periods longer than 10 years should also be eligible for refinance. Accordingly, effective February 18, 1974, the scheme was amended so that export credits extended for periods up to 15 years will be eligible to be refinanced by IDBI, subject, of course, to the transactions satisfying the other terms and conditions of the scheme.

Preshipment credit for a period exceeding 6 months to finance the processing and manufacture of goods to be exported may also be refinanced when linked with postshipment credit. No minimum or maximum limit applies

[8] See Chapter 7.

to the size of the export credit that may be refinanced.

The IDBI has been operating a scheme since December 1968 for financing a supplier's credit for exports of engineering goods and services on deferred payment terms. In December 1973, the IDBI introduced a Buyer's Credit Scheme in terms of which the IDBI would, in participation with eligible commercial banks in India, grant credits directly to foreign importers in connection with exports of capital goods from India. Another aspect that has widened the scope of the IDBI's export finance schemes was the grant of a special bank credit of Rs 25 crores to three financial institutions in Bangladesh to enable that country to import capital goods falling within certain specified categories from India. The credit is extended on a deferred credit period of 15 years at a rate of 5 per cent per annum and will be shared in India by the IDBI (50 per cent) with the United Bank of India and the United Commercial Bank which will together share the balance 50 per cent of the credit.

In this connection, it may be recalled that commercial banks have exhibited a strong disinclination to approach the IDBI to avail of refinancing facilities in regard to medium-term export credit because of the stipulation about the ceiling rate of interest to be charged from the borrowers. In special cases, the Reserve Bank should be prepared to waive this requirement so that the impact of ceiling rates does not unduly hurt the productive exports of commercial banks. In the case of the export of commodities which have ready markets abroad, the ceiling of the rates of interest to be charged by commercial banks on the exporters should be more flexible according to the demand for such loans. The Reserve Bank of India, on the other hand, with its responsibility to maintain an even keel between various sectors of economy will do well to consider the desirability of introducing a preferential rate of discount for export trade in those commodities in which competition for foreign markets is keen and, also, where the normal rate of return is low in comparison with the other sectors.

The scheme of social control and nationalisation of banks has referred to the three priority sectors (export trade being one of them) as deserving increased assistance from the banking system. It is suggested that the impact of ceiling rates on banks' earnings might be reviewed on the basis of experience and no hard and fast rule should be laid down. In order to enlarge the flow of credit to this priority sector, the stipulation as to the ceiling rate of interest to be charged on exporter-customers must be more liberal and flexible.

VI

Observations

Export finance is an important means of export promotion to earn foreign exchange in the modern world. Expanding exports need increasing credit facilities in the world markets today, which are essentially buyers' markets. Export finance as an instrument to stimulate export has, thus, a crucial role to play in achieving a self-generating and self-sustaining economy. It would be no exaggeration to claim that the smooth flow of exports and the scope for increasing

them can be significantly influenced by the finance and services provided by banks.[4] Provision of larger and cheaper export credit facilities is difinitely a significant element in the development of international trade. In fact, the generosity with which long-term credit can be, and is, offered by German exporters of capital goods, is held to be one of the prime factors for the success of Germany which is now challenging the lead of the USA in the world.

Export trade depends on various factors for which proper incentives and amenities should be adequately provided. Export credit has a preponderant role and the Reserve Bank will have to perform a yeoman's task in steadfastly pursuing a liberal credit policy to strengthen the economy of the country.

In a growing economy commercial banks are expected to play an increasingly important part in promoting exports by providing export finance in adequate quantities. What they need is adequate refinance at reasonable rates. The lack of adequate banking connections between India and her nontraditional markets is a serious gap which must be filled by the Indian banks. They should gradually become more and more outward looking by opening a well-planned network of overseas branches and rationalising their relations with correspondent banks. Commercial banks, moreover, will have to give a lead to exporters by providing them with better advice and information on the export trade. The Reserve Bank should formulate more liberal schemes and adopt a positive approach to free the credit going to finance exporters from the 'controlled expansion' of the credit policy. Commercial banks, on the other hand, have to ensure that every legitimate demand for credit from an exporter is met appropriately. They should realise that they have a vital role to play in the stimulation of exports, the provision of adequate advice and guidance in matters of finance to exporters should be regarded as a part of their normal business.

It is observed that banks generally have foreign exchange departments only at metropolitan centres and a few port towns. The number of centres where banks provide intensive export finance facilities are thus limited and should, therefore, be increased. The bankers also need to maintain a service cell to disseminate information about overseas markets as and when requested and particularly help new entrants in the field of exports overcome the initial difficulties in choosing the right market and in complying with attending formalities. For all the services, whether they are related to finance or advice, the bankers should serve as the direct, and consequently the most important, link for the exporter-customers. The guidance of the central bank in this direction either through day-to-day contact with the commercial banks, periodical inspections of the banks, or periodical meetings with the bankers and exporters at a regional level, will certainly help the bankers in realising their responsibilities. The problem of finance in the promotion of exports is complex and no single and easy remedy for its solution has been found in any country of the world. It calls for continuous and sustained effort from all the interested parties—from the central bank, commercial banks, Government and the exporters themselves.

[4] *The Banker*, London, April, 1965, Vol. CXV, No. 470, Article "Exports and the Branch Manager", pp. 236–242.

The insurance and guarantee schemes and present procedures of the ECGC should be, and could be liberalised. This liberalisation will inevitably result in an increased financial burden on the ECGC through meeting a larger number of policyholders' claims. This should not deter the Corporation. Here, too, the Japanese practice is a useful reference and should be adopted by the ECGC. The Japanese Government Export Insurance Board (Export Insurance Special Account), no doubt, operates in principle on a no-profit-no-loss basis, but in actual practice the operations of the Board have almost always been in deficit since the inception of the Board.[5] Unless the central bank and the Government are quite positive in their attitude, i.e., willing to take risks, the insurance and guarantee schemes for exports might not make significant progress.

The monopolistic position of foreign banks is a serious threat to the economic interests of India. The financing of the export trade in tea, for example, is concentrated exclusively in the hands of the foreign banks. The bulk of India's foreign trade is financed by foreign banks, mainly British, which have adequate connections with Europe and countries which were once a part of the British Empire. The lack of adequate banking connections between India and her nontraditional markets is a serious gap which must be filled by Indian banks. The expansion of overseas activities by banks headquartered in the USA is one of the most important developments in international finance during the last decade. The overall dimensions and the geographic focus of the foreign activities of American commercial banks are shown in the Annexure. During the last decade, their foreign business expanded at a rate far in excess of that recorded in their domestic business. Moreover, the overwhelming share of this growth occurred at their foreign branches rather than at their head offices.

The pattern of overseas branches indicates Indian settlements abroad, and not Indian trade overseas. Although India has substantial trading connections with the USA, Canada and Australia, no Indian bank has a branch in any of these countries whereas foreign banks in India enjoy the advantage of having branches at both the exporting and importing ends (see Annexure at the end of the chapter).

Despite the importance attached to the export trade as an instrument for economic progress it is surprising that neither the reporting channels nor the central coordinating system has been developed by the Indian banks yet. The major Indian commercial banks, including the State Bank of India, must be encouraged by the Reserve Bank to undertake a regular and systematic survey of the possibilities of opening branches in the more important trading centres of the world, particularly in West Asia, the Middle East, West Africa, Europe, North America and South America.

The spirit of innovation and enterprise, a study and emulation of the working methods of foreign banks together will equip the Indian banks to foresee opportunities of foreign trade and investment. The fact is that a country which

[5] For example, in case of the comprehensive shipment insurance scheme in Japan, the Government paid the policy-holders 1.6 billion yen (4.4 million) in 1965, as against a receipt of only 1.0 billion yen ($ 2.8 m) from overseas importers.

is able to withstand competition in foreign markets in its export business is already a considerable way towards a self-reliant and self-sustaining growth. Export finance is a new and complicated field. In the rapidly changing horizon of export trade in a developing economy, new problems in export finance may arise and new risks have to be faced by the commercial banks, new measures must be adopted and new rules framed by the Reserve Bank. On the part of the central bank, once a policy of export promotion is formulated and a scheme drawn up, there is still a need for efforts to adapt the scheme to the changing situation, further simplification of the procedures, and the popularisation of the scheme among exporters and bankers etc. This is particularly true at the early stages of the scheme. Also the guidelines issued by the Reserve Bank of India to the commercial banks in regard to their normal operations should be kept under continuous scrutiny to ensure that they do not constitute obstacles for the drive on export promotion.

Annexure 10.i

Summary of Operations of IDBI (Export Sector)

(Year: July-June) *(Amount in crores of rupees)*

Type of assistance	Sanctions					Disbursements			
	1972-73		1973-74		Cumulative sanctions since inception up to end June, 1974	1972-73	1973-74	Cumulative disbursements since inception up to end June 1974	Assistance outstanding as on June 30, 1974
	No. of applications	Amount	No. of applications	Amount		Amount	Amount		
1	2	3	4	5	6	7	8	9	10
Direct loans for exports	4	2.7	4	7.9	58.0	3.9	6.7	35.7	25.1
Refinance of export credits	2	0.1	3	2.7	28.6	2.2	1.0	24.6	6.0
Advance payment guarantee (Export credit)	—	—	—	—	1.8	0.1*	—	1.8*	0.96

* Guarantees executed.

Annexure 10.ii

IDBI'S Structure of Interest Rates (Export Credit)

(Per cent per annum)

	Rates prevailing before July 27, 1974		*Revised rates effective from July 27, 1974*	
	IDBI rate	*Ceiling on the rate to be charged by the financial institutions*	*IDBI Rate*	*Ceiling on the rate to be charged by the financial institutions*
Export Credit				
(a) Refinance against medium-term export credits	5.5	7*	5.5†	7 (No change)
(b) Participation export finance scheme (c) Buyers credit scheme	The rate on IDBI's portion of credit is such that after taking into account the participating bank's rate, the average rate to the exporter on the entire credit will generally be .65 per cent[1] (no change).			

* Maximum rate of interest chargeable by banks.

† The rate and the ceiling on it were raised from 4.5 per cent and 6 per cent to 5.5 per cent and 7 per cent, respectively, with effect from April 30, 1974.

[1] The rate was raised from 5.5 per cent to 6.5 per cent with effect from April 30, 1974.

Source: *Report on Currency and Finance*, 1973-74, Reserve Bank of India p. 213.

Annexure 10.iii

Statement Showing the Number of Offices Opened or Closed in Foreign Countries by Indian Banks during July 1973 to June 1974

No. of offices opened:	6 (Rose Hill, Bangkok*, Male, Kowloon, Paris and Dubai)
No. of offices closed:	Nil.

* Taken over the business of the branch of Indian Overseas Bank at Bangkok.

Annexure 10.iv

Geographic Distribution of Foreign Branches and Subsidiaries of US Commercial Banks, January 1, 1975

Area	*Number of banks**	*Number of foreign branches*	*Number of foreign subsidiaries*
Canada	1	—	2
Bahamas	72	80	7
Cayman Islands	43	44	1
Caribbean	6	58	4
South & Central America	6	180	8
United Kingdom	41	55	14
Europe	28	112	26
Middle East	6	20	2
Africa	5	4	9
Asia & Pacific	22	124	5
US Overseas & Trust Territories	4	55	1
Total	125	732	79

* Number of banks in each area will not add to total because a particular bank may have multiple locations.

Source: *Federal Reserve Board.*

11

The Reserve Bank of India and Exchange Control Administration

Exchange Control as an Essential Adjunct in the Scheme of Monetary Management

With the initiation of the development plans in the independent countries, which called for considerable expenditure of foreign exchange, the careful husbanding of the scarce foreign exchange reserves in the hands of the central banks became all the more necessary. The mobilisation of foreign exchange reserves and the administration of exchange control is interrelated. Legally, the Minister of Finance is responsible for the administration of exchange control, but usually the task is delegated to the central bank of the country. The officers of the central bank possess all the technical knowledge and experience for the administration of such control. Reliance again has inevitably to be placed on the central bank where exchange control is being employed as an instrument of monetary policy. Since World War I, the central banks of most countries came, either as a natural development in monetary control or as an emergency measure, to play an increasingly important role in foreign exchange operations.[1] Professor Sayers has also laid great emphasis on this aspect of the role of the central bank in underdeveloped countries.[2] For the successful implementation of the Five Year Plans to promote economic development, the Indian economy needs an even flow of exports and imports, and for that an effective regulation of exchange mechanism. This buttresses the need of including exchange control as an important and essential adjunct in the scheme of monetary management in the developing economy of India.

One of the primary objectives of exchange control is to conserve, augment, and completely mobilise the total supply of foreign exchange available to the

[1] De Kock, *Central Banking*, Staples Press Ltd., New York, 1946, p. 256.
[2] Sayers, R. S., *Central Banking After Bagehot*, Clarendon Press, Oxford, 1957, p. 114.

nation. The objective is not merely to prevent unauthorised use of foreign exchange but also to ensure its prompt transfer to the official pool.

II

Aim and Administration of Exchange Control

Exchange control was first introduced in India by virtue of the emergency powers derived from the Defence of India Rules promulgated at the outbreak of World War II on September 3, 1939. The financial provisions of those Rules formed the basis for the administration of the control. These war time emergency powers were later placed on a statutory basis by the Foreign Exchange Regulation Act, 1947, which came into force on March 25, 1947. Several amendments were made to this Act subsequently. The latest amendments which tightened the enforcement provisions of the Act, became effective in April 1965. The types of transactions which are affected by the Foreign Exchange Regulation Act are, in general, all those having international financial implications. In particular, the Act empowers the Government of India and the Reserve Bank of India to control and regulate

(a) Purchases, sales, and other dealings in foreign exchange, and maintenance of balances at foreign centres;
(b) Export and import of currency, cheques, drafts, travellers cheques and other financial instruments, securities, jewellery, etc.;
(c) Procedure for realisation of proceeds of exports;
(d) Transfer of securities between residents and nonresidents and acquisition and holding of foreign securities; and
(e) Payments to nonresidents or to their accounts in India.

In more recent years, the scope of Indian exchange control has also undergone some changes *vis-a-vis* Nepal. Although there is no exchange control between India and Nepal, from 1962 all foreign exchange commitments of Nepal in respect of the import of goods into Nepal, freight, insurance charges, service charges, etc., have been met by the Nepal Rastra Bank.

Exchange control in India has undergone little structural change, but it has acquired a new meaning and purpose in the context of the country's developmental effort under the successive Five Year Plans. It has now become an essential instrument of national economic policy. By the middle of the Second Five Year Plan, sterling balances reached a level which left no cushion for developmental purposes. With import requirements already cut to the minimum and with a continuing necessity for developmental imports and for the servicing of foreign loans, a special responsibility developed in the area of exchange control in regard to the country's external finances.

In brief, the aim of exchange control is to preserve foreign exchange resources by rationing them and to distribute them among competing import demands in order to obtain maximum advantage for the nation, to prevent flight of capital, and to make speculative or arbitrage operations in exchange impossible. To this end, all dealings of the public in foreign exchange are

required to be transacted only through authorised dealers.

As in many other countries, the system of exchange control is intended to conserve the total foreign exchange earnings of the nation from all sources, both from visible and invisible items of exports, and to regulate the use of foreign exchange resources for different purposes in such a manner as to promote all-round development of the country. Supply of foreign exchange for import payments is rationed by the Government of India by the issue of import licences. Under the Foreign Exchange Regulation Act all transactions in foreign exchange by residents of India are required to be done through the medium of specific banks to whom licences to deal in foreign exchange have been issued by the Reserve Bank. These banks are called authorised dealers in foreign exchange.

Authorisation in the form of licences to deal in foreign exchange are ordinarily granted only to those banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934. In certain cases only limited licences authorising dealings in the currencies specified therein are issued. The Reserve Bank may, without assigning any reason, refuse to grant, or revoke if already granted, the authorisation of any bank to deal in foreign exchange. This would happen if, in its opinion, a bank acted contrary to any of the provisions of the Foreign Exchange Regulation Act or any directions issued by the Reserve Bank, or if it is satisfied that there are other reasons rendering it undesirable to grant or continue the authorisation. Authorised dealers should refer any applications for foreign exchange or other transactions which do not fall within the scope of their authority to the Reserve Bank.

Authorised dealers in foreign exchange may exercise the powers indicated below subject to the circulars and notifications issued from time to time by the Reserve Bank:

(a) to deal in foreign currencies and for that purpose, to open and maintain accounts in such currencies;
(b) to approve applications from residents for purchase of foreign currencies; and
(c) to maintain rupee accounts in the names of nonresidents and to pass debits and credits to such accounts.

An important development in the sphere of exchange control during the year 1973–74 was the Foreign Exchange Regulation Act, 1973, which replaced the earlier Act (Foreign Exchange Regulation Act, 1947) with effect from January 1974. Another development was the scheme instituted by the Reserve Bank for providing protection against the adverse effect of fluctuations in exchange rates on the export earnings of exporters of goods on deferred payment terms. The basic structure of the new Act is the same as that of the earlier Act. The more important provisions of the new Act are Sections 28, 29 and 31 which seek to regulate the activities in India, of persons resident outside India (including Indian citizens), foreign citizens resident in India and companies (other than banking companies) which are incorporated abroad as well as their branches and companies in which the nonresident interest is more than 40 per cent. The Reserve Bank has been entrusted with the responsibility of administering all these provisions. Besides these, various other provisions have been introduced

for strengthening the enforcement machinery, preventing evasion of the regulations and enhancement of penalties for contravention of the regulations. Two significant steps relating to the exchange operations of the Bank were taken during the year 1973–74, the provision of long-term forward exchange cover for exports and the extension of the spot and short-term forward exchange transactions to cover the deutsche mark and Japanese yen.

The work relating to the administration of exchange control in the Reserve Bank is organised under a separate department called the Exchange Control Department. The Department is under the charge of the Controller, assisted by the Joint Controller, Deputy Controllers, Assistant Controllers and Exchange Control Officers. As mentioned earlier, the day-to-day administration of control by the Bank involves a large measure of delegation of powers to the authorised dealers. In matters so delegated to them, the authorised dealers may themselves approve remittances of small amounts for miscellaneous purposes such as subscriptions to overseas institutions, admission fees, pensions, etc., in order to reduce the number of applications to be submitted to the Reserve Bank for approval, the sale of exchange being merely reported to it in such cases together with the form filled in by the applicant. Remittances of larger amounts are permitted only after approval by the Reserve Bank.

Under the regulations currently in force, release of exchange in regard to all categories of travel requires the prior approval of the Bank, excepting Haj pilgrimage for which there is a separately constituted authority—the Port Haj Committee, Bombay. Applications for the release of exchange (other than Haj pilgrimage) and also for booking of passages are considered on an individual basis and approved according to certain rules of essentiality. No exchange or even booking of passage is at present allowed for pleasure travel by Indian nationals in view of the continued difficult foreign exchange position.

III

International Liquidity—The Scheme of Special Drawing Rights[3]

A passing reference to the international monetary system in terms of the role of the International Monetary Fund and proposals for an augmentation of international liquidity under its auspices may perhaps not be out of place here. In its simplest form international liquidity consists of all the resources of gold and foreign exchange that are available to the monetary authorities of different countries for meeting deficits in their balance of payments.

[3] The Unit value of SDRs was made equal to that of the United States dollar—at a metric system weight of 0.888671 gram of gold. \$1=ISDR=Rs 7.50=0.888671 gram of gold. In January 1972 the SDR Unit value was raised to \$1.0857 (Kent, *Money and Banking*, Holt, Rinehart and Winston, Inc. p. 93). Effective from July 1, 1974, the IMF has put into operation a new method of valuing the SDRs using the technique known as 'Standard basket'. The scheme envisages inclusion in the basket agreed currencies on the percentage weights to be assigned to each currency. At present 16 currencies are included in the basket.

The Special Drawing Rights, or the SDRs as they are briefly styled, are essentially similar to the concept of credit creation which central banks undertake in each country to supplement the resources of the banking system to meet the monetary requirements or the liquidity needs of the domestic economy. The translation of this concept to the international plane has had an intellectual appeal to economic thinkers for quite a long time. However, there are obvious practical difficulties. While the sovereign authority of a State backs a paper currency and the monetary authority is vested both with powers and responsibilities to regulate it, on the international plane in transactions between different countries any creation of credit had to be backed by resources that are mutually acceptable and a way had to be devised to ensure the equitable distribution of these resources between different countries.

Under the proposed scheme, the value of the SDRs will be fixed in gold. They will be distributed to members of the IMF in proportion to their quotas. The participants would undertake an obligation to provide their currency in exchange for the SDRs when called upon to do so. The intention is that countries with a strong balance of payments and substantial reserves would provide the requisite backing of real resources to the SDRs. The main merit of the scheme is its essential simplicity and flexibility. The SDRs are a form of reserve assets which are suitable for incorporation in countries' reserves; they are also a form of international credit creation on the analogy of domestic credit creation subject of course to certain safeguards. The SDR scheme would permit the IMF to augment the stock of world liquidity in the light of emerging requirements. The major breakthrough, indeed, is that additions to liquidity are no longer dependent on the tenuous supply of gold for monetary purposes or on the increase in the obligations of the reserve currency countries. Thus, the object of the deliberate reserve creation of an unconditional type, in relation to need, would be achieved to supplement the present facilities of the Fund. It thus marks a major step in managing the international monetary system.

The SDR scheme, which is the result of evolving ideas on a suitable form of reserve creation is indeed the intellectual descendant of Lord Keynes' proposals at Bretton Woods for an International Clearing Union though it does not go as far. The reaction to Keynes' proposals then was that it cast too great a responsibility on the creditor countries to finance payment deficits. Keynes' idea that the system should have a built-in elasticity to meet future contingencies appeared to some to be farfetched. With the wisdom of hindsight today we cannot but marvel at the foresight of Keynes in this as in so many other matters.

The SDR scheme not merely marks a major step forward in managing international money on a rational basis: it also represents the first serious effort in the postwar period to move away from gold as the centre of the monetary system by providing for fiduciary reserve creation. In fact as the stock of monetary gold is not likely to expand much, and as holdings of reserve currencies cannot rise without creating problems for countries like the USA and the UK, addition to world liquidity would have to come from reserve creation through the SDRs. But, this depends very much on the degree of international economic cooperation that is forthcoming and the willingness of countries to entrust more and more

responsibility for international monetary management to the still embryonic international central bank—the International Monetary Fund.

However, we must recognise that the membership of the IMF is not universal. A significant part of the world's trade and payments is outside the pale of the Fund system. We refer to the trade of the Socialist countries of East Europe and China. The trade of the USSR and East European countries with the outside world has been growing. India's trade with them has increased sharply. So, too, has the trade between Eastern Europe and Western Europe and, today, the share of the Socialist countries in international trade is over 10 per cent of the total and it is likely to grow further with the opening up of more trade channels between them and the rest of the world.

The system of payments evolved by the Socialist countries has a strong built-in mechanism for preventing imbalances. On the other hand, because there is no real convertibility of currencies, it has resulted in trade being conducted at prices higher than those in the international market as a whole. Yet, over the years new trends have been appearing in East European trade and payments which have tended to narrow the gap between them and the IMF system. The distance between the two is still significant despite the sign of triangular deals replacing multilateral deals and the increasing points of contact in trade, payments, and other relationships between the Eastern bloc countries and the rest of the world. We mention this fact of the two separate trading systems only to emphasise the point that the international system is still far from being a world system and there is a whole range of problems in that field yet to be covered.[4]

IV

Observations

The Bank of England, according to Einzig,[5] kept aloof from intervention in the foreign exchange market until the Great Depression. The old principle of the Bank that the participation in exchange transactions for its own account was not a proper sphere of activity for a central bank and that the latter should exert its influence on exchange rates through its discount rate policy, open market operations in securities, etc., and also, under the gold standard, through redeeming its notes in gold, has been replaced in most countries by the central bank dealing in foreign exchange in order to directly regulate exchange rates as well as for the purpose of regulating money market conditions. In this connection, the purchase or sale of foreign exchange by the central bank has the same effect on the money market as purchase or sale of securities, but it should be borne in mind that the scope of the former is limited by the balance of payments position of a country.[6] The technical limitations of credit control as well as its restricted scope and range under modern economic and financial conditions have rendered it more necessary to employ other methods as supplements or temporary

[4] *Reserve Bank of India Bulletin*, November 1968, pp. 1408-1421.

[5] *The Banker*, July 1944.

[6] De Kock, H. H., op. cit., Chapter XIV

alternatives to other instruments of credit control.[7] The supplementary or alternative methods which have attracted most attention since World War II are the use, *inter alia,* of the regulation of exchange rates and exchange restriction in one form or another either at the same time or as alternatives. As the demand for and supply of foreign exchange are generally determined by the monetary and credit conditions, the central bank seeks:

> ...to regulate money market conditions also by means of the customary instruments of credit control, which would in turn help to influence the exchange rates in the desired directions....[8]

Exchange control may represent a helpful protective measure in an actual emergency. But it may also turn into a powerful tool of political and economic control in the hands of the central bank, a partner of the Government. By manipulating the exchange rate the central bank, as a powerful controlling agency of the Government, can give direction to imports and exports—based not on the concept of comparative costs but on political expediency. Exchange control may also allow a strong country to acquire a stranglehold over a weaker one—it can give the strong countries the power to influence the direction of trade of the weaker countries and that is undesirable in the interest of world trade. The weaker country may have to import goods which it really does not want, and in any case its freedom of choice of imports is restricted. All in all, the system cannot be recommended except under special circumstances of war or as a temporary measure to tide over a period of fundamental disequilibrium in a country's balance of payments position.

Exchange control is nothing but the outcome of the political division of different countries of the world. For instance, Cuba has now seceded from the dollar area because of the political transformation of that island country.

To conclude, it would be fair to say that membership of the international economic community confers not only privileges but obligations as well. The countries accumulating surpluses have a responsibility to discharge by taking on a larger share of capital assistance to the less developed countries. It should not be beyond the ingenuity of leaders of international monetary thought to devise schemes whereby measures to augment international liquidity can be combined with steps to increase the international capital flows by way of development assistance. Thus, countries that acquire SDRs can be made to put these to work in the form of releasing some of their own resources for capital assistance. There have, indeed, been suggestions that such a link should be established. Professor Triffin recognised the possibility of such a link and Mr Maxwell Stamp made a distinctive contribution by suggesting a direct link between augmentation of liquidity through deliberate reserve creation and an increase in developmental assistance. An Expert Group appointed by UNCTAD has also come out strongly in favour of linking schemes of international monetary reform with an increase in developmental assistance. India also has warmly supported the idea of such a link and stressed the importance of combining the creation of

[7] Ibid., Chapters V and VIII.
[8] Ibid., p. 257.

international liquidity with the provision of development finance.

The argument for a link between international monetary reform and enlargement of capital assistance should not cause surprise. After all the World Bank and the International Monetary Fund have always been regarded as twins. Between them, and in cooperation with each other, they constitute the hopes for a rational international economic order designed to promote world economic growth. Just as the balance of payments can be balanced at a low enough level of output and employment only to the detriment of the country concerned and the world economy, so, too, there are dangers of a shrinkage of the flows of development capital if this latter is regarded as a separate problem for merely discretionary action. Only when the shorter term and longer term aspects of the balance of payments are thus viewed together, can we say that the Grand Design set out at Bretton Woods will reach its logical fulfilment.[9]

[9]Sources: (i) Speech of the Governor of the Reserve Bank of India, Mr L. K. Jha at the Annual Meeting of the IMF and the World Bank on November 30. 1969, Washington.

(ii) Speech of Mr Morarji Desai, India's then Finance Minister at the Rio de Janerio meeting on September 29, 1967.

(iii) *Reserve Bank of India Bulletin*, November 1968.

12

Regulation and Control of Banks

Object of Banking Legislation

Bank behaviour and thus the contribution of the banking system to economic development—whether positive, negative or neutral—is strongly conditioned by the structure of the banking system which, in turn, is shaped primarily by legislation and other government policies. The structural characteristics of the banking system, and the laws, regulations, and customs that govern its behaviour will normally be important determinants of its effectiveness.[1] The importance of a comprehensive review in depth of banking legislation and other laws affecting banking business in the context of banking development in India is obvious. Hence it was but natural that the Government should have asked the Banking Commission to "review the existing legislative enactments relating to commercial and cooperative banking".

Experience over a long period of years, both in the developed and underdeveloped countries, has shown that the banking system will not function satisfactorily without some supervision by the central bank or the Government. In fact, the whole process of economic life is so dependent on the banks that the maintenance of satisfactory banking discipline is indispensable to achieve the broad economic objective. Undoubtedly, there is a close connection between bank behaviour and economic prosperity and stability. Hence, various legislative safeguards have been imposed to ensure the safety of the funds of the depositor, and to encourage the development of banking on sound lines to steer the economy along the desired direction. The measures introduced to regulate and control the banking system in India, as in many other countries, have emerged from basic economic conditions which are of a changing and developing character. In India where the emancipation of banking is yet to come, the philosophy of self-regulation is not possible and legislative control measures become imperative to direct the banking system.

[1] Cameron, Rondo, Ed., *Banking and Economic Development, Some Lessons of History*, Oxford University Press, London, 1972, Chapter 1, pp. 1-125.

More than 70 per cent of the legislation enacted by Parliament in India since Independence pertains to economic matters. The dominant features of this legislation are the gradual extension of State control over various sectors of the economy and the provision of facilities for economic development in consonance with the Directive Principles of State policy in the Constitution of India.

The problem of the safety of the deposits—the primary object of bank regulation—is intimately related to the question of the liquidity of banks. The problem of liquidity, again, is interwoven into that of banking functions. The salient features of commercial banking regulation and control in India are studied here from the standpoint of how far the relevant provisions are calculated to protect the interests of the depositor by improving the liquidity position of banks, as also to what extent they have been effective in regulating the flow of bank credit into desired channels, with special reference to planned economic objectives.

II

Movement for Banking Reforms in the War and Post-War Periods

Banking legislation as such does not aim at the protection of the bank shareholder. Company Law looks after his interests. The fundamental objective of bank legislation is to safeguard the welfare of the depositor. Again, banking legislation is chiefly concerned to ensure short-term liquidity. Until recently, banking legislation did not give careful consideration to the promotion of long-term liquidity. The framers of laws in various countries have endeavoured to secure bank liquidity through the prescription of minimum requirements of capital and reserve, statutory cash reserves, regulation of the type of banking assets, maintenance of minimum liquid assets, and segregating long-term investment from commercial banking functions.

The movement for banking reform during the War and post-War periods has not been confined to India alone. This desire for reform, as usual, has been reflected in an increasing measure of banking control. Surprisingly economists and monetary authorities even in the USA, a country which puts its faith in free enterprise, have introduced measures of control of commercial banking in post-war years the like of which has not been witnessed even in socialist Britain.

Even before the War the Board of Governors of the Federal Reserve System in their Annual Report of 1938 had given a graphic picture of the condition of conflict and confusion among the various agencies exercising supervision over commercial banks and had severely condemned the existing "gaps in authority", "overlapping authorities" and "diffusions of supervising responsibility". The problems of bank organisation and control have now come to engage the attention of bankers and economists in a manner they had never done before; and proposals for the reform of banking and for effecting its modernisation have emanated from many quarters in recent years.

There are five types of controls in the USA intended to preserve the integrity of bank credit. The controls are intended to provide safety and can be classified

as those relating to (i) adequate bank capitalisation and periodic examinations; (ii) note issues; (iii) deposit reserves; (iv) speculative loans; and (v) the insurance of small depositors by the Federal Deposit Insurance Corporation.[2]

Recent discussions of commercial banking reform have principally centred round the twin problems of regulation by law and complete nationalisation. A third approach to banking reform is to be found in the USA in the One Hundred Per Cent Reserve Plan. This approach occupies the middle ground between self-policing and outright nationalisation. Under it commercial banks will be allowed to continue in private ownership but will be made to undergo a radical change in their functions. The aim of legal regulation nowadays is to bring commercial banks more and more under state control and supervision, but yet preserve their private ownership; while that of nationalisation is to bring them under complete public ownership. The One Hundred Per Cent Reserve Plan, while not seeking to impose state ownership, does not propose to leave the banks entirely under self-regulation. Thus, we find that the question today is not whether there should be regulation by law but how far, and in what direction, that regulation should go.[3]

In the era of postdepression banking legislation, most of the notable legislative measures for the regulation of commercial banking operations were enacted in Germany,[4] Belgium[5] and Switzerland.[6] In Argentina and the British Dominions thorough revision of banking laws was effected and detailed regulations relating to commercial banking were passed. In this respect the most significant exceptions were countries like the UK, France and the Netherlands.

The recent banking laws in Guatemala, Paraguay, the Dominican Republic, Korea and Australia have endeavoured to endow the banking system in those countries with a degree of flexibility adequate to meet their peculiar economic conditions. The banking laws in these countries have carefully considered the credit needs of small, undeveloped, primarily agricultural countries, whose economic prosperity is closely related to the exports of a few primary commodities, the supply of which is subject to the vagaries of the weather or the depredations of insect pests and where demand is exposed to large cyclical fluctuations. An analysis of the more important features of banking laws in these countries demonstrates that the framers of the laws have embodied in the legislative provisions the necessary instruments of regulation and control in the hands of the monetary authorities to curb unhealthy banking practices and undesirable credit expansion. In spite of the wide disparity of conditions, a factor, responsible for a striking resemblance in the various postdepression banking legislations is that coordination between central and commercial banking policies had to be ensured.[7]

[2] Bye and Hewett, *Applied Economics*, The World Press, Calcutta, 4th edn., Chapter XV, pp. 347-365.

[3] Watkins, L. L., *Commercial Banking Reforms in the United States*, Michigan Business Studies, Vol. VIII, No. 5, Ann Arbor, Michigan, 1938, pp. 398-399.

[4] Law of December 1934 and Decrees of February and July 1935 and June 1936.

[5] Decrees of July, August and November 1935.

[6] Law of November 1934 and Decree of February 1935.

[7] *Money and Banking*, League of Nations, 1937-38, Vol. I, p. 97.

A novel feature of recent banking legislation in underdeveloped countries like Guatemala, the Dominican Republic, Paraguay and Korea is the explicit permission granted to commercial banks to participate to some extent in the financing of medium and long-term credit. We have studied elsewhere (Chapter 8) at length the recent trends of authoritative opinions in different countries in favour of making a limited deviation from conservative banking practice.

III

Inadequacy of the Companies Act—Special Banking Legislation

World War II witnessed the mushroom growth of small and weak banks in India indulging in speculative activities and thereby endangering the trust money of the public. Special banking legislations became essential as the Companies Act was not adequate in regulating specialised activities like banking. Such legislation has been enacted in most western countries, except in the UK where there is no special banking legislation apart from the Companies Act, the purpose of legislation being served by tradition, convention and case laws that have developed over the course of centuries. Thus, the Banking Companies Act, 1949[8] was passed in India and came into force on March 16, 1949. The Reserve Bank of India was vested with wide and sweeping powers of supervision and control of banks under the provisions of the Act to enable it to respond to new needs.

With the enactment of the Banking Regulation Act in 1949 and the amendment of Section 42(2) of the Reserve Bank of India Act in 1949, the powers of the Reserve Bank of India relating to inspection and control of both scheduled and nonscheduled banks were considerably enlarged. Further, the Banking Regulation Act made it necessary for banks to obtain a licence from the Reserve Bank to commence or carry on banking business or open new branches (Sections 22 and 23). A minimum liquidity ratio of the percentage of cash, gold or unencumbered approved securities to the total of time and demand liabilities in India has also been stipulated (Section 24). Under the Act, the Reserve Bank of India has also been empowered with very wide powers to determine policy on advances to be followed by commercial banks, to give directions with regard to the purposes for which loans and advances may or may not be made, the margins to be maintained in respect of secured advances, the maximum amount of advances which may be made by the banking company, the maximum amount up to which guarantees may be given, and the rates of interest to be charged on advances.[9] The Act also required schemes of arrangement and amalgamation to be examined and sanctioned by the Reserve Bank. The provisions of Indian legislation with regard to the purposes for which loans and advances may or may not be made by banks (Section 21) are modelled closely on the lines of Section 27(1) and (2) of the Australian Banking Act,

[8] Now the Banking Regulation Act, 1949.

[9] Section 21(1), 21(2)(a), 21(2)(b), 21(2)(c), 21(2)(d), 21(2)(e) of the Banking Companies Act, 1949 (now the Banking Regulation Act).

1945,[10] from where even the language appears to have been borrowed. This control over lending was regarded not only as an essential continuing power in the postwar transitional period but also the "means of checking an unbalanced expansion of credit resulting in sectional inflation and distortions in the structure of production".[11]

The above comment by Professor Wilson in the Australian context is of significance in the Indian postwar transitional period too, considering the similarities of the different sectors of the agricultural economy in the two countries.

IV

New Amendments to Face New Challenges in a Planned Economy

As new problems arose in succeeding years, the legislative and executive provisions governing the conduct of banking business were amended to face the new challenges, and whenever circumstances demanded, suitable exemptions from these provisions were also granted to the banks. The powers of regulation and control of the Reserve Bank of India have been considerably enlarged by a series of amendments to the original Banking Regulation Act, 1949, as well as the Reserve Bank of India Act, 1934, as demanded by the changing circumstances of the developing economy. The highlights of banking legislation and the powers of the Reserve Bank over the banking structure provide a useful measure of how much these legislative provisions have contributed to the purpose of planned economic development.

Thus, on the eve of the inauguration of the Second Plan, the framework of the Reserve Bank of India Act was made more flexible. In 1956 and 1957, a set of amendments to the Reserve Bank of India Act provided that the link between the note issue and gold and foreign exchange reserves could be abandoned but the amount of gold and eligible foreign exchange must not be allowed to drop below Rs 200 crores, and of this amount gold reserves must not be less than Rs 115 crores. The Act also empowered the Reserve Bank of India to vary the cash reserves which scheduled banks must maintain from 5 to 20 per cent in the case of demand deposits, from 2 to 8 per cent in the case of time deposits. This device is termed as 'controlled expansion'—a monetary counterpart of the expression 'development with stability'.

[10] cf. Australian Bank Act, 1945, Sec. 27(1): Where the Commonwealth Bank is satisfied that it is necessary or expedient to do so in the public-interest, the Commonwealth Bank may determine the policy in relation to the advances to be followed by banks, and each bank shall follow the policy so determined:

(2) Without limiting the generality of the last preceding subsection the Commonwealth Bank may give directions as to purposes for which advances may or may not be made by banks.

[11] Sayers, R. S., Ed., *Banking in the British Commonwealth*, Clarendon Press, Oxford, p. 91, vide J. S. G. Wilson's, "The Commonwealth Bank of Australia".

V

Adequacy of Bank Capital: Capital-Deposit Ratio and Capital-Assets Ratio

The principal ways in which the adequacy of bank capital was secured in the postdepression and prewar banking laws were (i) by prescribing a legal minimum capital (as in Belgium, Norway and Canada); (ii) by correlating the capital (and reserve) to the deposit liabilities (as in Switzerland and Argentina) and (iii) by linking capital to the population of the place in which the bank was operating (as in the USA). Usually the fixing of a proportion between the capital and its deposits is a more satisfactory method of securing adequate capitalisation and protecting the interests of the depositors than the mere prescription of a minimum capital structure. As a writer has observed in *The Statist*, it is a mathematical certainty that the risks of depositors increase at an accelerating rate with every diminution in the ratio between capital and deposits.[12]

Let us now examine how far the capital-deposit ratio serves as a suitable guide to supervisory policy and how far it is a proper measure by which capital may be judged ample or inadequate.

The powers of control and supervision of the Reserve Bank of India have been considerably augmented by a series of amendments to the original Banking Companies Act, 1949 (now the Banking Regulation Act) as well as the Reserve Bank of India Act of 1934. The main objectives of some recent amendments have been to strengthen the capital funds of the banks, to increase their cash reserves and liquidity requirements, and to prevent the diversion of deposits away from the banking system to the nonbanking financial intermediaries.

In spite of substantial increase in the profits of banks in India in the decade 1950–51 to 1960–61, the growth of capital and reserves has been slow, especially in relation to the growth of deposits. As a result, the ratio of owned funds to deposits continued to decline, from 13 in 1939 and 9 in 1950 to 5 per cent in 1960.[13] As shown in Table 12.1 the total paid-up capital and reserves of all banks in India came to Rs 82 crores at the end of 1962 of which published reserves accounted for somewhat less than half. The overall ratio of paid-up capital and reserves to deposits, which represents the capital base, was 5 per cent, but this generally varied inversely with the size of banks. Thus, banks with deposits of over Rs 100 crores had as low a ratio as 3 per cent while non-scheduled banks had a ratio of 16 per cent, the smallest category among them had it as high as 25 per cent. The pertinent feature is the declining capital-deposit ratio for practically all banks, but particularly the larger ones, principally because of the marked growth of deposits and an almost stationary level of transfer from profits to reserves. The ratio was in fact halved over ten years. This development is accounted for entirely by the trends in numbers, paid-up capital, and in the reserves of scheduled banks, while nonscheduled banks became a small and shrinking entity.

In sharp contrast, the capital-deposit ratio in 1960 was 18.1 per cent in

[12] *The Statist*, British Banking Selection, May 27, 1944, p. 5.

[13] *Annual Report of the Central Board of Directors*, Reserve Bank of India, 1962, p. 34.

TABLE 12.1. Ratio of Paid-Up Capital to Deposits, 1951-62

(Amount in crores of rupees)

(A) End of year	1951 (First year of the First Plan)		Total	1962 (First year of the Third Plan)		Total
	Scheduled banks	Non-scheduled banks		Scheduled banks	Non-scheduled banks	
1. No. of reporting banks*	76	306	382	66	212	278
2. Deposits †	636	36	672	1,680	37	1,717
3. Paid-up capital	33	6	39	40	4	44
4. Reserves	26	2	28	36	2	38
5. (3+4) as % of 2	9	23	10	5	16	5

* Excluding foreign banks.
† excluding counterpart deposits.

(Last Year of the Third Plan)

(B) End of Year	1965
1. Number of banks (scheduled and nonscheduled)	109
2. Total deposits	3,073
3. Paid-up capital and reserves	95
4. Ratio of paid-up capital and reserves to deposits	3.4

Sources: (1) Reserve Bank of India, Statistical Tables Relating to Banks in India, 1965.
(2) Crick, W. F., Ed., *Commonwealth Banking System*, Clarendon Press, Oxford, 1965, p. 203.

Indonesia, 14.3 in Brazil and 13.6 in the Philippines amongst the underdeveloped countries; and 9.5 per cent in the USA, 8 in Switzerland, 7.7 in Canada and 7.1 in West Germany in the developed countries. In the UK alone the ratio is only 3.6 per cent which is still better than many banks in India. But, India can ill afford to adopt the standard of the UK where secret reserves are of a high order and the banking system is compact—it has only a handful of institutions. The capital-deposit ratio of the leading banks in India is illustrated in Table 12.2.

Even in the advanced countries a trend is perceptible towards maintaining a parity of deposit growth and capital base which will be evident from Table 12.3. The comparative picture of the ratio of paid-up capital to total deposits is available from the following data. The capital deposit ratio in India is half of that in the USA (Table 12.2A).

In the circumstances, the provisions in the Banking Regulation Act, 1949, with regard to paid-up capital and reserves which were introduced in the pre-Plan period became out of date with the vigorous expansion of both deposits and credit and the remarkable diversification of activities under the stimulus of the Plans. Reserves represent a cushion to meet unforeseen contingencies. The immediate task before the banking system was to strengthen capital funds by augmenting reserve funds and strengthening inner reserves, so as to enable

TABLE 12.2. Ratio of Paid Up Capital and Reserves to Total Deposits of 15 Leading Banks in India

(Percentage As on Dec. 31, 1960)

Name of the Banks	*Owned capital-deposit ratio*
1. Allahabad Bank	2.9
2. Bank of Baroda	3.6
3. Bank of India	5.5
4. Bank of Maharashtra	3.4
5. Canara Bank	3.4
6. Canara Industrial Bank	4.7
7. Central Bank	3.4
8. Devkaran Nanjee (Dena Bank)	3.6
9. Indian Bank	4.2
10. Indian Overseas Bank	4.8
11. State Bank of India	2.2
12. Union Bank	8.9
13. United Bank	6.8
14. United Commercial Bank	4.5
15. Punjab National Bank	2.0

TABLE 12.2A. Ratio of Paid-Up Capital to Total Deposits

(Percentage)

	India	*United States*
1960	3.96	9.6
1961	3.94	9.32
1962	3.98	9.23
1963	3.79	9.35
1964	3.52	9.03
1965	3.31	9.26
1966	2.90	9.23
1967	2.72	8.86

Source: *Federal Reserve Bulletin*, 1963-67.
Statistical Tables Relating to Banks between 1964 and 1967.

TABLE 12.3. Ratio of Capital Funds to Deposits in UK, USA and West Germany

	UK	*USA*	*West Germany*
1950	2.4	7.5	3.1
1960	3.7	9.5	7.1
1963	5.2	9.1	8.2

Source: *Indian Institute of Bankers*, Bombay, Vol. XXXVII, January 1966, No. 1, p. 15.

it to undertake its increased responsibilities in developmental programmes. The regulation of the Reserve Bank of India in the circumstances requiring banks to transfer 20 per cent of their profits to reserves till the ratio of paid-up capital (and reserves) reached 6 per cent of the deposits is not unfair. There is no statutory compulsion in this respect as yet. The Reserve Bank desires that this ratio should be adhered to as a matter of convention.

It is rather curious that the Reserve Bank has introduced the outmoded capital-deposits ratio as a criterion of the minimum adequacy of a bank's funds instead of the capital-assets standard which is being increasingly adopted in recent banking legislation. This method of capitalisation (capital-deposit ratio) fails to distinguish differences in the composition of banking assets of different kinds of banks operating in different areas. Banks operating in the rural areas and bearing the undiversified risks of local agriculture and industry are not nearly so liquid as those in the money markets, which have considerably diversified earning assets of far smaller credit risks. The capital protection adequate for the latter type of banks, expressed as a percentage of their deposits, would be hopelessly inadequate for rural banks. It must also be borne in mind that the character of bank assets and constituents of bank portfolios change periodically. In such circumstances a drop in the capital-deposit ratio would not necessarily indicate that the banks have grown weaker.

According to Professor Robinson[14], a minimum capital-assets ratio of 10 per cent would be a more appropriate supervisory objective than the outmoded capital-deposit ratio of an equivalent amount. It is from the depreciation of assets that losses arise. The magnitude of the losses which a bank may incur is thus related directly to the quantity and quality of its assets and not to the volume of the deposits. In the circumstances it may be argued that assets provide a more reasonable guide to capital requirements, and as a guide to supervisory policy the capital-assets standard would be more appropriate than the capital-deposit ratio. It would further provide a more direct and effective control over bank investment policies. This alternative approach has been adopted by new banking laws in some underdeveloped countries such as Guatemala,[15] Korea,[16] Paraguay and the Dominican Republic[17] to measure the adequacy of bank capital and surplus. In addition, the capital-assets standard can also be employed as an effective weapon of selective credit control.

The strength of a commercial bank does not depend upon the size of the reserve fund but the form in which the fund is maintained. Curiously enough, banking legislation though meticulous as regards its size, has seldom specified the types of assets in which it should be invested. There are only two or three instances where banking laws have stipulated the manner in which the reserve fund should be held. In Belgium all of it has to be held in the form of public or Government guaranteed securities. In Bulgaria only a certain portion of it

[14] Robinson, R. I., "The Capital-Deposit Ratio in Banking Supervision", *Journal of Political Economy*, February 1941, Vol. XLIX, pp. 41-53.

[15] Art. 20, Bank Law of Guatemala, also Grove, D. L., *New Guatemalan Bank Law*, pp. 3-4.

[16] Art. 15, The General Banking Act, Korea, April 1950.

[17] Art. 12 (Paraguay), Art. 18 (Dominican Republic).

has to be maintained as a deposit with the National Bank.[18] In Poland joint-stock banks are obliged to invest at least 50 per cent of their reserves in first class securities.[19] The omission of some such requirement has made the obligation to accumulate a reserve fund virtually meaningless.

Neither the capital nor the reserve fund can be regarded as a factor contributing to the 'liquidity' of the banks in the sense in which the expression is understood here. They tend to secure long-term liquidity and afford protection to the depositor in the event of the bank's liquidation. The capital is a guarantee fund set aside by the shareholders for the ultimate protection of the depositors and other creditors of the bank. The reserve fund, similarly, acts as a cover against losses through possible depreciation of the assets in which the reserve fund is held in the event of the winding up of the institution. Even then it must be emphasised that there is no point in building up a reserve fund without requiring it to be held in the form of assets which would retain a considerable proportion of their value during a depression. While the principle of building up reserve funds from undeclared or net profits is sound, the setting aside of so high a percentage as 20 per cent might involve the payment of small dividends over long periods, which will impair the credit of the banks.

The position in different countries in this respect is indicated in Table 12.4.

TABLE 12.4. Minimum Proportion of Yearly Net Profits to be Carried to Reserves

(Percentage)

Norway	20	Colombia	10
Sweden	15	Ecuador	10
Argentina	10	Japan	10
Bolivia	10	USA	10
Bulgaria	10	Romania	5
Chile	10	Switzerland	5
		Turkey	5

With the exception of Norway, provisions in the Indian legislation of the percentage of net profits to be carried to the reserve fund are the most stringent regulations of their kind.

VI

Bank Liquidity through Prescription of Cash Reserves and Liquidity Requirements

The second objective of some recent banking legislation has been sought to be attained by (i) abolishing the existing distinction between demand and time

[18] Allen, Cope and Dark, et. al., *Commercial Banking Legislation and Control*, Macmillan & Co., London, 1938, p. 13.

[19] *Money and Banking*, League of Nations, 1937-38, Vo. 1. p. 97.

liabilities for the purpose of calculating reserve requirements and by (ii) raising the reserve and liquidity requirements.

In India there was a continuous decline in the liquidity ratio of banks from an average of 42 per cent during 1951–55 to 34 per cent in 1956–60. During the same period, the credit-deposit ratio rose from 61 per cent to 69 per cent.[20]

A revision of the policy as of the appropriate statutory minimum level of the liquid assets ratio, with a distinction between the reserve ratio and the liquid assets ratio, was accordingly incorporated in 1962 into the Amendment of the Banking Regulation Act, 1949, and the Reserve Bank of India Act, 1934. Combining these two requirements, the minimum liquid assets ratio of the scheduled banks would be 37 per cent, reserve ratio 4 per cent [Section 42(1) of the Reserve Bank of India Act, 1934] and liquid assets ratio 33 per cent[21] [Section 24 of the Banking Regulation Act, 1949] instead of the old level of 20 per cent.

It is true that inadequate liquidity may bring about disaster in the economic structure and distort the flow of savings. On the other hand, the liquidity of the banking system may be regarded as a basic factor shaping the lending policies of banks and, consequently, a principal determinant of the cost and availability of bank credit to borrowers.[22]

Fixed legal minima are hardly effective in promoting bank liquidity. The higher the legal reserve ratio, the lower is the liquidity of the banks. Their strength depends not on their legal but on their surplus reserves. Thus the statutory cash reserves of commercial banks might guarantee ultimate protection to the depositors in the event of liquidation, just as paid-up capital and reserves would do, but they are of limited significance as providers of short-term liquidity—the kind of liquidity with which we are vitally concerned. It is only when the provision of legal cash reserve ratios is coupled with the further provision of their variation in an emergency that they are of some value in enabling banks to meet sudden and unexpected withdrawals.[23] From this point of view, banks in the USA, Mexico and New Zealand, where the ratios are flexible, and in Germany and Argentina where the observance of the cash ratio may be temporarily suspended, stand on a better footing than the scheduled banks of India under Section 42 of the Reserve Bank Act.

It may be recalled that the primary function of flexible minimum cash ratios is not to improve the liquidity of the banks but to furnish the central bank with a new weapon to control the money market. Even here, it is debatable how far this weapon of credit control would be effective in a narrow market as in India where the banks are not wedded to the practice of maintaining rigid cash ratios. The ratios are sufficiently variable to be a real obstacle to the use of both open market operations and the variable reserve ratio. The same factor, observes Professor Plumptre, which stultifies open market operations in such markets

[20] *Annual Report of the Central Board of Directors*, Reserve Bank of India, 1962, p. 35.

[21] The percentage was 30 in the 1939 Bill and 25 in the 1946 Bill and was reduced to 20 in the 1949 Act.

[22] *Federal Reserve Bulletin*, August 1966, p. 1093.

[23] Allen, Cope and Dark, et. al., op. cit., p. 67.

will render the variable reserve ratio a crude and insensitive weapon of credit control.[24]

In India there is no short loan market in the sense in which there is one in London. For the Indian banks this avenue of liquidity is not available. In Australia and New Zealand, where too a short loan market in the same sense does not exist, banks have adopted the practice of holding money at call or on short notice in the London market and these funds are reckoned among their liquid assets. It is not a widespread practice with the Indian banks, however, to employ their funds in this way in the London money market. In the Indian banking legislation, the components of liquid assets have been restricted to cash, gold and unencumbered securities alone (Section 24 of the Banking Regulation Act, 1949), thus rendering their scope much too narrow in relation to the peculiar circumstances of India.

Sometime ago Treasury Deposit Receipts (TDR) occupied the front rank in the liquid assets of British banks but their claim to be regarded as quick assets is scarcely greater than that of the seasonal advances of smaller banks in India. Again, whatever may be urged against the case of including seasonal advances under quick assets, there is not the slightest ground for excluding 'bills discounted' as a component from the list of such assets. First class commercial bills and any other bills rediscountable with the Reserve Bank should legitimately be included under them. For banks which derive a high proportion of their resources from time deposits, so that liquidity of assets is not necessary for them in the same sense or extent as in the case of the other banks, a smaller prescription of liquidity may be suggested.

The different devices introduced in the Commonwealth countries to affect the liquidity position of the banking system have a striking similarity. They are merely alternative ways of achieving the same goal, that is, the control of the availability of credit via the control of bank liquidity. They have in common the characteristic of being a 'nonmarket tool of credit policy'—freezing a certain form of bank assets and cash or cash plus Government paper. The volume of assets thus immobilised is generally expressed as a ratio to their total deposits or as a percentage of an increase in their total deposits since a selected base date.[25]

In the ultimate analysis, liquidity is associated with the efficiency of the banking system and economic solvency of the economic system. In Australia, the liquidity ratio of 25 per cent introduced in 1953 has since been reduced to a level of 14 per cent.[26] The authorities must realise that the liquidity ratio should be determined in such a way that the momentum for expansion is not halted. In view of the *bona fide* requirements of the private sector in a mixed economy, while fixing the liquidity ratio, the authorities should carefully ensure that the

[24] Plumptre, A. F. W., *Central Banking in the British Dominions*, The University of Toronto Press, Toronto, Canada. 1940, p. 278.

[25] Olakanpo, J. Obasanmi, *Central Banking in the Commonwealth*. 1st edn., Book Land P. Ltd., 1965, Chapter VII, p. 177.

[26] According to the Annual Report of the Reserve Bank of Australia, 1960, the present ratio is 16 per cent (see Olakanpo, op. cit., p. 83).

ability of the banking system to create credits is not drastically curtailed.

VII

Regulation of Acceptance of Deposits by the Nonbanking Companies

As regards the third objective of recent amendments the supervision, control and regulation of nonbanking financial intermediaries which accept deposits has been called for, not only for ensuring adequate protection to the depositors, but also for more effective management of the monetary system.

Nonbanking financial intermediary (NBFI) is a generic term in economic literature and refers to financial institutions whose liabilities are not accepted or used as a means of payment (or money) in the settlement of debts. The main difference between banks and NBFIs arises due to the differences in the nature of their liabilities. However all the liabilities of banks cannot be used as a means of payment. Again some of the NBFIs are referred to as 'near-banks'. There is thus an element of arbitrariness in the definition of NBFIs. Still NBFIs in India can be identified as hire purchase finances institutions, investment companies, *chit* funds,[27] loan and finance companies and *nidhis*.[28]

NBFIs generally do not accept demand deposits; hence they compete with banks only in time deposits. They have been able to thrive on differential in rates paid on deposits. This differential in the rates causes a transfer of deposits from banks to NBFIs or attracts funds which otherwise would have come to the banking system. Equally, it may well be that a part of the funds of NBFIs consists of deposits which are transfers from currency holdings and, to that extent, represents the process of resource mobilisation by financial institutions. Thus NBFIs can be regarded as being partly in the organised sector and partly in the twilight zone between the organised and unorganised sectors. This defines their role in mobilising savings. On the lending side, the loans of NBFIs are made for purposes like purchase and repairs of houses, acquiring durable consumer goods or just for plain consumption, whereas the overwhelming part of loans made by commercial banks is for industrial or commercial purposes. Thus NBFIs fill an important gap and the growth of NBFIs and banks has been parallel because while borrowers of greater creditworthiness could borrow from

[27] The *chit* fund or *kuri* is perhaps the oldest of the indigenous financial institutions in India. The word 'chit', i.e. a written note on a small piece of paper, suggests its origin. Basically, it involves regular periodical subscriptions by a group of persons and arrangements under which each member of the fund is entitled to the periodical collection. There are many variations of chit funds. Broadly, they can be classified into three categories: (i) simple chits, (ii) prize chits, and (iii) business chits.

[28] *Nidhis*, also known as mutual benefit funds or permanent funds, are peculiar to South India, particularly Tamil Nadu. These are companies registered under the Indian Companies Act and deal only with their members. In the majority of cases, the value of their share is only Re 1 and hence almost any body can become a member. The major source of their funds is the deposits (mostly in the form of recurring and fixed deposits) from their members. They make advances to their members at reasonable rates of interest. These are mostly secured loans.

commercial banks, others would approach the NBFIs.

The liabilities of the NBFIs are not convertible into cash on demand; hence they are not close substitutes of money. Though effectiveness of monetary policy would not be affected on this account, it may be adversely affected in other ways. For instance, in addition to providing business credit in the speculative and other nonpriority sectors, NBFIs may also provide margin money in respect of advances where high margins have been prescribed as part of selective credit controls. NBFIs are not subject to any liquidity requirement. Thus the earning potential of banks which are subject to specified liquidity requirements is less than that of NBFIs which can recoup the high cost of deposits by charging high interest rates on their lendings. The high rates of lending of NBFIs are partly due to the large unsatisfied demand for credit. This is possible because the clientele of these institutions was, at least until recently, neglected by commercial banks. The risk element is another factor which is so great that it sometimes jeopardises the depositors' interests.

One of the main objectives of the enactment of the Banking Laws (Miscellaneous Provisions) Act, 1963, is to enhance the Reserve Bank's powers over commercial banks as well as to regulate the acceptance of deposits from the public by nonbanking institutions. The Act simultaneously amended the Banking Regulation Act, 1949, the Reserve Bank of India Act, 1934, and the State Bank of India (Subsidiary Banks) Act, 1959.

The existing legislation till then did not provide for any control over nonbanking companies accepting deposits from the public. Of late, the volume of deposits accepted by them has been growing steadily and the rates of interest offered were compartively high. For ensuring adequate protection to depositors and more effective management of monetary and credit policy it was considered necessary that the Reserve Bank should be in a position to control and regulate such companies. The amendments have empowered the Reserve Bank to regulate or prohibit the issue of prospectus or advertisement by such companies soliciting deposits from the public, to call for returns and information relating to deposits, and to give them directions in regard to receipt of deposits, and to prohibit acceptance of deposits under certain circumstances. The Reserve Bank is also empowered to inspect the books and accounts of any such company for the purpose of verifying the correctness or completeness of any statement, information or particulars furnished by it to the Bank.

An unfettered growth of deposits outside the banking system, and proliferation of institutions depending mainly or wholly on deposits from the public can blur the effectiveness of a central banking policy. It was, therefore, to provide a measure of protection to the depositors and to facilitate regulation of the credit system to the advantage of the country, that the Reserve Bank of India, between 1966, and 1967, introduced under the Banking Laws (Miscellaneous Provisions)Act, 1963, a series of curbs on the acceptance by nonbanking companies of disproportionate deposits in relation to their capital structure. According to the recent directives of the Reserve Bank, the nonbanking companies (other than hire purchase and housing finance companies) are prohibited from accepting deposits for periods of less than six months. The

ceiling on the total deposits they can accept is 25 per cent of the paid-up capital plus free reserves less accumulated loss balance, i.e. net owned funds and another 15 per cent as deposit guaranteed by directors. This ceiling restriction is not applicable to hire purchase finance companies. The unsecured loans raised by companies against guarantees given by their directors which had been excluded from the purview of the directions were, with effect from January 1, 1972, subjected to the same ceiling restrictions as applicable to deposits when it was found that the exemption was being abused. With effect from September 1, 1973, exemption from the ceiling restrictions is available in respect of some types of deposits, if certain conditions regarding the nature of security and margin are fulfilled. Some relaxations have also been made in favour of small-scale industrial companies. Those which have paid-up capital and free reserves not exceeding Rs 3 lakhs and which accept deposits from not more than 50 persons are exempt from the restrictions regarding ceilings, repayment of excess deposits, and particulars are to be specified in application forms and advertisements soliciting deposits, etc., for a period of three years from July 1, 1973, provided they are duly registered with the State authority concerned. The other small-scale industrial companies are allowed to accept deposits up to a level not exceeding the aggregate of their paid-up capital and free reserves.

The Reserve Bank issued a new set of directions called the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973, on August 23, 1973, which came into force from September 1, 1973. These directions are applicable to companies conducting prize chits, as also those conducting genuine or customary types of chits. While the subscriptions received by customary chit funds are exempt from the restrictions, those collected in respect of prize chits are treated, for the purposes of the directions, as deposits and the restrictions regarding tenure, ceiling, advertisements, etc., have been made applicable to them. Subscriptions to the customary type of chit funds have been excluded from the purview of the directions, since such chit funds are of a self-liquidating nature and partake the character of a mutual benefit scheme. The sums disbursed as prize amounts under such schemes cannot exceed the *sala* amount (i.e. the aggregate of subscriptions for each instalment) and each member in turn gets the prize amount, the foreman company being entitled to income by way of commission determined as a fixed percentage of the *sala* amount (generally 5 per cent) to cover expenses, etc., for conducting the schemes.

The role of the Reserve Bank is confined mainly to controlling acceptance of deposits by companies in the overall context of regulating the monetary and credit structure of the country; it does not extend to controlling the other activities or the management of such companies. Members of the public who place their funds with a nonbanking company in the form of deposits or unsecured loans or otherwise should not, therefore, presume that their monies are fully protected, or are absolutely safe, merely because the company claims to have complied with the Reserve Bank's directions, nor should they be under the impression that they can look to the Reserve Bank for redress in the event of the company failing to meet its obligations in regard to the repayment of deposits.

Acceptance of deposits by a company from the public and their repayment are

purely matters of contract between the depositor and the depositee company. In case of any breach of contract, the remedy open to a depositor is to enforce his rights through a court of law. The Reserve Bank's directions are no guarantee against any company (and its depositors) coming to grief through mismanagement or otherwise. Nor can the Reserve Bank compel a company to repay its dues to the depositor.[29]

The nonbanking financial intermediaries are capable of playing an important and useful role in the Indian economy by creating financial instruments to suit the wide and varied preferences of savers and borrowers in the economy. No systematic attempt seems to have been made so far to encourage these financial institutions to play a more dynamic role in the economy. There is, therefore, a need to regulate the activities of the NBFIs with the objective of encouraging them to enter the mainstream of the activities of the organised financial system. There are considerable differences in the working of the different NBFIs and the extent and nature of regulation should be fashioned according to the characteristics of the individual institutions. The bulk of the NBFIs in India are noncorporate bodies. From the point of view of regulating as well as strengthening them it would be desirable to encourage such institutions to incorporate their undertakings. For purposes of regulation NBFIs should, in general, be classified into two categories—'approved' and 'nonapproved'. While a specified minimum degree of control may be exercised on all NBFIs, the 'approved' ones, which will be only corporate bodies and which satisfy certain additional requirements of the regulating authority, should be accorded special and favourable treatment. Details of the criteria to be adopted for 'approval' of an institution would ultimately depend on the judgment of the Reserve Bank regarding the way in which the operations of such an institution are conducted. The Banking Commission, in this connection, has recommended a Banking Code to regulate all the deposit-taking institutions (see Annexure, 12. iii).

VIII

Bank Mortality: Introduction of Deposit Insurance

The two bank failures in the South in 1960 necessitated the Reserve Bank of India to frame further legislative measures so that repetition of bank mortality may not shatter the fabric of confidence of the depositors and thereby impede economic growth. The establishment of the Deposit Insurance Corporation on January 1, 1962, on the model of the Federal Deposit Insurance Corporation in the USA has created a favourable climate for reviving public confidence in the banking system.

Since the beginning of 1968, however, the facility of insurance cover for bank deposits was raised to Rs 5,000 (at present it is Rs 10,000) for an account in a bank. It is estimated that increased insurance will cover about 90 per cent of bank accounts and 40 per cent of deposits. The increased cover is certainly a

[29] Report of the Banking Commission, p. 417.

welcome measure as it is apprehended that banking operations may become more hazardous and uncertain in times ahead due to the stipulation to employ bank credit in priority sectors such as agriculture, small-scale and cottage industries, the export sector, and new enterprises, which do not demonstrate a certain profit sustainability even though the social gains involved are indisputable.[30]

IX

Consolidation of the Banking System and Strengthening of the Banking Structure

The regulatory powers of the Reserve Bank of India in respect of the banking structure include consolidation of the banking system through compulsory mergers (Section 45 of the Banking Regulation Act, 1949), voluntary amalgamation (Section 44A) and transfer of assets and liabilities under Section 293(1) of the Companies Act, 1956. In its efforts towards consolidation and integration the Reserve Bank has, in recent years, been increasingly fostering the growth of economically sound and sizeable regional banking units which could cater to the banking needs of the region more effectively. Very often, the Reserve Bank itself has taken the initiative and persuaded those banking units which do not hold promise of developing into viable units within a reasonable period, to amalgamate with or transfer their liabilities and assets to viable banks. The total number of banks absorbed in this manner was 7 in 1966 as compared to 33 in 1965 and 79 in 1964. Table 12.5 throws a better light on the Reserve Bank's performance in this field.

In 1956, there were 423 banks, all but 89 of them nonscheduled banks. In December 1967 there were only 100 banks, and only 24 among them were nonscheduled.[31] This is a striking reduction in the number of operating banks, especially amongst the nonscheduled banks, and it is considered to be the most basic structural change that has taken place in the banking system in the Second and Third Plan Period (1956-66).

The comprehensive banking legislation in 1949 and subsequent amendments thereto invested the Reserve Bank with enormous powers for rehabilitation, integration and modernisations of the Indian banking system. The Reserve Bank has been using these powers coupled with the powers and responsibilities conferred by the Reserve Bank of India Act, 1934, and its subsequent amendments fairly regularly. The Reserve Bank took a number of steps for strengthening the banking system and has many solid achievements to its credit but a lot remains to be done still.

One basic weakness of the Indian banking structure has been its numerous units most of which are too small to be viable. Another weakness has been the

[30] The number of insured commercial banks is 80 and the insurance scheme now covers 423 eligible cooperative banks.

[31] *Reserve Bank of India Bulletin*, December 1967, p. 1679, only 7 reporting nonscheduled banks at present.

TABLE 12.5. Bank Merger, Amalgamations and Transfers of Assets and Liabilities

Year	*Voluntary Amalgamations under Section 44A of the Banking Regulation Act, 1949*	*Compulsory Mergers under Section 45 of the Banking Regulation Act, 1949*	*Other Mergers*[1]	*Transfer of Assets & Liabilities under Section 293(1)(a) of the Companies Act, 1956*	*Total*
1950	4	—	—	—	4
1951	2	—	1	—	3
The First Plan Period					
1952	—	—	4	—	4
1953	—	—	1	2	3
1954	—	—	—	1	1
1955	—	—	—	3	3
1956	—	—	—	—	—
The Second Plan Period					
1957	2	—	2	—	4
1958	4	—	2	1	7
1959	4	—	—	4	8
1960	2	—	—	5	7
1961	1	30	2	3	36
The Third Plan Period					
1962	3	1	2	5	11
1963	2	1	4	15	22
1964	7	9	1	62	79
1965	5	4	3	21	33
1966[2]	—	—	2	5	7
Total	36	45	22	129	232

[1] Banks taken over by the State Bank of India and its subsidiaries.

[2] No substantial change has been made during the Fourth Plan Period in respect of banks which have been granted moratorium under Section 45 of the Banking Regulation Act, 1949. (*Report on Currency & Finance*, 1973-74, p. 276.)

Sources: (1) *Trend and Progress of Banking in India*, Reserve Bank of India, 1965, p. 17 and 1966.
(2) *Journal of the Indian Institute of Bankers*, Vol. 39, April-June, 1968, p. 175.

adoption of practices unsuited to both economic efficiency and integrity. Yet another has been the existence of substandard units. So, in 1960 the Reserve Bank was empowered to bring about mergers. The exceptionally large number of mergers witnessed in 1964 (Table 12.5) was due to the pronounced emphasis on a dear money policy in recent years, particularly since the last quarter of 1963. This policy, coupled with higher liquidity requirements and restrictions on the availability of central bank credit, meant that banks must redouble their efforts to mobilise more deposits. So an acute competition for deposits developed much to the discomfort of small banks. The licensing policy of the Reserve Bank towards opening of branches was the second important cause. Under this policy, it has been extremely difficult to obtain licences for opening branches

at places already well served by banks. So the big and medium banks were inclined to take over small banks with offices in these centres. The small banks, too, were not unwilling to oblige as they found it difficult to compete with the better managed banks and follow the higher standards of business prescribed by the Reserve Bank. The number of banks came down markedly from 365 in the beginning of 1960, to 108 in March 1965, 100 in 1966, 17 in February 1969 to only 7 in August 1974. The elimination of weak banks, so to say, on such a large scale has mitigated much structural weakness in the banking system and has helped boost economic efficiency and financial integrity. The Reserve Bank should now give adequate attention to the postmerger problems of the transferee banks.

However, a word of caution may be sounded. Obviously, the diverse character of our economy provides scope for the coexistence of both small and larger banks. With the emphasis we are placing on decentralisation of economic power and opportunities, it is right that the development of both big and small banks should go side by side as small banks are not inherently inefficient. The objective of amalgamation must not aim at a merger of all the small banks. The small but efficient banks should not be constrained to die dishonourable death for no fault of their own. Official policy in this regard should be more objective. In this connection, it may be remembered that the British banking system, as far back as 1918, pronounced against indiscriminate mergers for bringing into existence a superstructural form of banking. The Governor of the Bank of England made it clear that any further move to merge banks (the latest and biggest proposal to merge Barclays, Lloyds and Martins, has been referred to the Monopolies Commission) would not be officially approved.[32] Apart from the adverse public reaction to these mergers, there is a problem of organisation. It is argued that the industries and services cannot be efficiently reorganised as quickly as the recent unprecedented rate of merging implies, and that managements should strive for efficiency, not for size for its own sake.

It is improper to imagine that advantage will automatically trickle down once a merger is effected. Bank mergers are no sure and easy paths to economy and growth. A merger no doubt offers an opportunity to rationalise the bank's internal organisation, extend branch banking, and enter the international market. The chairman of Barclays Bank rightly remarked, "being a labour intensive industry, we shall not be able to hold down the cost of acquiring deposits, our raw material, or providing our services unless we can streamline our organization".[33] Unless, therefore, serious efforts are undertaken following a merger, to thoroughly overhaul management and manpower and to rationalise internal organisation, few merger benefits will accrue.

It is interesting to note a striking contrast in the official policies towards bank mergers in India and the USA. In May 1960, the American Bank Merger Act was passed putting restrictions on bank mergers, while in the same year, the Reserve Bank of India assumed powers to compel mergers of weaker banks with

[32] *The Journal of the Indian Institute of Bankers*, Vol. 39, April-June 1968, No. 2, pp. 170-175.

[33] Alhadeff, David A., "A Reconsideration of Restrictions on Bank Entry, "*Quarterly Journal of Economics*, 1962.

stronger ones. It was feared that the increasing trend of mergers in the USA, sometimes involving giant banks was, perhaps, responsible for curbing healthy competition, and conferring monopoly powers on some banks in certain areas. This necessitated the Act in accordance with which a bank, before approving any proposal for merger, must obtain a written report on the competitive factors involved in the proposed action from the two Federal banking agencies and from the Department of Justice. The Department of Justice has been putting more obstacles in the way of bank mergers since 1960, perhaps, under the impression that the sole function of the Act was restrictive.

A predominant factor responsible for important bank mergers in India was favourable official policy. The initiating causes[34] on the part of aggressive banks, like some of the ambitious American banks, did not exert much influence over the trend of bank mergers in India, perhaps, because the Indian banks which have tried to regulate competition through Interbank Agreements may not have experienced such keen competition as American and British banks did. Usually such a degree of competition results in a desire on the part of big banks to acquire monopoly powers by enlarging the size of their operations. Weak and unsound banks, which are more vulnerable to merger activity, facilitate the ambitions of big banks. But as every bank is a distinct personality in itself, representing a particular community's or local interest in India, it would also stubbornly struggle for existence, and one wonders if left to themselves, there would have been so many mergers had it not been for the vigorous efforts on the part of the Reserve Bank of India to consolidate the banking system.

Despite the large-scale amalgamation and absorption (Table 12.5), it may be noted that it had no adverse effect on the extension of banking facilities in India. The progress of the extension of banking facilities will be evident from Table 12.6.

The fundamental objective of the Reserve Bank's policy in regard to branch banking continues to be a phased expansion of branches in urban centres along with the provision of banking facilities in semiurban and rural areas. The branch expansion programme gained momentum after the nationalisation of the

TABLE 12.6. Extension of Banking Facilities
The Third Plan and the Fourth Plan Period

	The Third Plan Period				
1960-61	*1961-62*	*1962-63*	*1963-64*	*1964-65*	*1965-66*
4,993	5,141	5,280	5,608	5,973	6,275

Date of Bank Nationalisation	*The Fourth Plan Period*		*End of June in*	
July 19, 1969	*1971*	*1972*	*1973*	*1974*
8,321	12,013	13,622	15,362	16,936

[34] The Comptroller of the Currency in 1954 cited five initiating reasons—(1) need to increase volume of business, (2) need or desire to better services. (3) desire to expand lending limits. (4) normal urge to excel in growth and (5) desire to improve earnings.

major commercial banks and the introduction of the Lead Bank Scheme. The average population served by a bank office has declined from 92,000 in December 1960 to 65,000 in July 1969 and further to 35,000 in December 1974.

It was generally the policy of the Reserve Bank to accord preferential treatment to cooperative banks in the matter of opening branches in rural areas and small towns to the point of discouraging commercial banks from opening branches in places already served, or likely to be served, by cooperative banks. The Reserve Bank has been following a rural-oriented branch licensing policy. Licences are issued to banks in the ratio of one office for urban centres and one office for metropolitan or port towns against every two offices opened in rural or semiurban centres by the banks which had more than 60 per cent of their offices in the rural or semiurban centres. In the case of other banks, the ratio is one office for urban centres and one office for metropolitan or port towns against every three offices opened in rural or semiurban centres. A certain measure of compulsion is thus being exercised for getting banking facilities to areas which have not enjoyed them hitherto.

A little foresight and enterprise on the part of the commercial banks would enable them to pursue a progressive branch expansion programme in the rural sector. In the rural branch extension venture the staff maintained at the head office and in the branches must be adequate in number and highly competent. In the branches in particular, we are convinced, the commercial banks will not be able to produce the necessary impact on rural business by economising on the number or the status of staff.[35] It is well known that both the Reserve Bank of India and the commercial banks have not been adequately alert in the past over this particular issue. It is hoped that the influence of the Reserve Bank of India will help in framing an appropriate recruitment policy of the commercial banks in future.

In respect of inspection and licensing of banks, also, the Reserve Bank's performance leaves much to be desired. It is in these aspects that the Reserve Bank is reluctant to throw sufficient light. In fact, it prefers to be silent on them in its Annual Reports. Its inclination to be secretive may be understandable but not necessarily justifiable. This policy unwittingly provides shelter to some undesirable practices and elements in the banking world which no amount of policing by the central banking authority can eliminate. It would be pertinent to comment that the failure of two important scheduled banks, even after a decade of inspection and directives, has jolted the economic structure and caused serious misgivings in the minds of the banking public. The objectives of the provisions for licensing of banks are designed to ensure the continuance and growth of only sound banking companies and to discourage indiscriminate floating of banking companies. In terms of Section 22 of the Banking Regulation Act, 1949, all the banking companies which existed prior to this Act were allowed to carry on banking business unless a licence was refused. But all the new banking companies were required to obtain a licence before commencing banking business. The Act also provided a three-year time limit to the existing

[35] *Reserve Bank of India Bulletin*, December 1967, p. 1639.

banking companies for fulfilling the conditions for getting the licence. The intention here was to give the banks sufficient time and opportunity to set their business in order. The Reserve Bank of India could not refuse a licence to a banker till March 1952 in view of the three-year amnesty since the passing of the Banking Companies Act (Banking Regulation Act) in 1949. The position of banking companies which had applied for a licence on or before September 16, 1949, pending a decision on their application, and were carrying on banking business, is anomalous. As on June 30, 1971, they still number 16 and an expeditious decision on the application of such banks, which has been pending for two decades and a half would remove this anomaly. It is, indeed, intriguing that these banks were allowed to operate without licence even after a lapse of twenty-five years since the Act came into force and annual inspection by the Reserve Bank was instituted. It appears that a substantial number of nonscheduled banks were granted licence whereas some sizeable scheduled banks were allowed to operate without licence. Thus, the coexistence, of over a long period, of unlicensed scheduled banks with licensed nonscheduled banks is a curious phenomenon in the Indian banking system. The inordinate delay in obtaining a licence by a banker in itself demonstrates a lack of its capability to satisfy the standards of eligibility. In order to maintain soundness, integrity and confidence-inspiring factors in the banking system, the banking business as a whole should be brought under licence. A time limit should be fixed for the old unlicenced banking concerns to obtain a licence with proper legal sanction for default. Enough lenience has been shown to the erring banks and plenty of time given to them to adjust to the requirements of law. There should be only one single type of bank in India, whether big or small—a licenced bank.

The present basis for classifying banks into scheduled and nonscheduled has lost its significance. Under Section 42(6) of the Reserve Bank of India Act, 1934, a banking institution could claim inclusion in the Second Schedule of the Act provided (a) it satisfied the Reserve Bank that its affairs were not being conducted in a manner detrimental to the interests of its depositors, and (b) its paid-up capital and reserves had an aggregate value of not less than Rs 5 lakhs. Since all banks came within the sweep of the Banking Regulation Act, 1949, condition (a) applies to all of them pursuant to the provisions of the Act. Even with reference to the capital requirements, as set out in condition (b), after the Banking Companies(Amendment)Act, 1962,all banking companies commencing business after that date are required to have a paid-up capital of not less than Rs 5 lakhs. With reference to cooperative banks, the question of capital structure may assume some significance; but any distinction based essentially on the size of the capital of banks alone does not commend itself. In the revised scheme of banking regulation, there is no need for such a distinction between banks.

X

Regulation and Control of Cooperative Banking

When the Banking Companies Act, 1949, was passed,it was not necessary to

regulate cooperative societies carrying on banking business as they were subject to the provisions of the Cooperative Societies Acts of the States. Moreover Cooperative Societies being a State subject, it was then considered appropriate to leave the regulation of the business of cooperative banks to the States. However, the Reserve Bank had to give financial assistance to a large extent, directly and indirectly, to cooperative banks. In order to ensure that the concessional finance granted to them was utilised for the purposes intended and that it reached the ultimate borrowers at a comparatively reasonable cost, the Reserve Bank had to evolve a scheme of voluntary inspections of cooperative banks. This did not prove to be effective. Moreover, 'banking' was a Central subject and Parliament could not absolve itself of the responsibility to regulate this business, even if it was carried on by cooperative societies. Hence, the Banking Laws (Application to Cooperative Societies) Act, 1965, was passed by Parliament extending the provisions of the Banking Companies Act, 1949, to cooperative societies doing 'banking' (as declined in the 1949 Act)—though not to all of them—subject to modifications. With the extension of the regulation to cooperative societies, the name of the legislation, Banking Companies Act, was not suitable and this resulted in its being renamed the Banking Regulation Act. Thus with regard to cooperative societies doing 'banking', the legislation of both the Centre and of the States is applicable.

As the Constitution stands, the primary question with reference to cooperative banks is the reconciliation of the jurisdiction, of the Centre and of the States. The concern of both the jurisdictions is real, and cannot be avoided. A recent decision of the Nagpur Bench of the Bombay High Court[36] has held that so far as the banking business is concerned, the Reserve Bank will have control over the working of the society as this does not conflict with the control of the society by the Cooperative Department as the functions of the two bodies are different. The best way of reconciling the claims of the Central and the States' jurisdictions in regard to cooperative societies doing banking is to make them subject to banking regulations in matters which will not encroach on the States' jurisdiction. The Banking Commission has recommended that the jurisdiction to regulate moneylenders and moneylending and also cooperative credit agencies should be transferred either to the Union List or to the Concurrent List. Such transfers can be effected only by a constitutional amendment.

XI

Regulation and Control of Indigenous Banking

Indigenous financial agencies comprise two broad categories: moneylenders and indigenous bankers. The primary distinction between the moneylender and indigenous banker is that while the former lends his own funds, the latter acts as a financial intermediary by accepting deposits or availing himself of bank credit. In other words, the indigenous banking system is regarded as a true

[36] Special Civil Application No. 897 of 1970 decided on April 30, 1971.

financial intermediary in the sense that its ability to purvey funds is largely dependent on the outside resources it is able to mobilise. Another distinguishing feature is that the transactions of the moneylender are conducted in cash while those of the indigenous banker are based on dealings in short-term credit instruments for financing the production and distribution of goods and services.

The main charge against indigenous banking agencies is the usurious rate of lending and the widespread difference between the borrowing and the lending rates. Interest rates in the unorganised sector are always high—generally between 18 and 36 per cent per annum, and in some economically backward regions over 75 per cent per annum. The rate of interest charged combines the cost of funds and an allowance for risk. Furthermore, apart from interest, most indigenous banking agencies tag on incidental charges such as brokerage, stamp fees and charity, which added together escalate the cost of credit to the borrower by another 2 to 3 per cent for every transaction.

The focus of the recommendations of the Banking Commission is on how best to institutionalise the lending and financial operations of indigenous bankers, thereby extending the area of operations of the organised financial system and harnessing extra resources for meeting the credit needs of retail trade, small industries and other small borrowers. With this as the objective, the recommendations aim at introducing a certain measure of financial and social discipline into their activities. The activities of the various types of indigenous bankers are hardly subject to any regulation. Organisationally, indigenous bankers are sole proprietary or partnership concerns and the provisions of the Banking Regulation Act, 1949, do not apply to them. The constraints imposed by the Moneylenders' Act prevailing in the various States are inadequate to guard fully the interests of the public in relation to the indigenous bankers.

Indigenous bankers (those who accept deposits from the public for the conduct of their business) should be regulated according to the scheme of the Banking Code outlined in the Annexure and those who do not accept such deposits are really a class of moneylenders.

Regulation in the form of detailed supervision and periodic inspection of the indigenous bankers is not possible as it would involve building up a large and costly inspection machinery. Reliance on self-regulation through the Indigenuos Bankers' Association is also not feasible. The best way to control the business of indigenous bankers would be through commercial banks. The Reserve Bank should exercise indirect influence over the business of indigenous bankers through the medium of commercial banks by laying down guidelines for their dealings with indigenous bankers. These guidelines could pertain to the type of *hundis* to be selected, the overall quantum of limits to be sanctioned, the maximum amount per maker and some formula for sanctioning individual limits. Commercial banks, in turn, should call for regular returns from indigenous bankers and require them to maintain adequate internal inspection procedures. The indigenous bankers should fulfil the following requirements in order to be entitled to discounting facilities with commercial banks: they should not engage in trading activity, their minimum capital requirements and a ceiling on the total discounting limits should be prescribed; they should agree to maintain books of

account in the usual recognised manner and have them annually audited and certified by a recognised firm of auditors; they should furnish annually to the Reserve Bank a summary statement of the volume and nature of business (to be prescribed by the Reserve Bank of India) and preferably they should be members of an association and must not be encouraged to borrow from more than one bank. The Reserve Bank and commercial banks for their part are required to make an annual assessment to ensure that advances granted by them are directed towards the desired segments of the society.

It is neither necessary, nor practicable, for indigenous bankers to have a direct link with the Reserve Bank. From the administrative aspect, refinancing of indigenous bankers directly by the Reserve Bank will involve labour disproportionate to the amounts of refinance both for the banks and the Reserve Bank as the *hundis* are for small amounts and the day-to-day turnover (receipts and deliveries) in them would be large. Also, on due dates, the Reserve Bank would in that case have to watch repayment of a large number of *hundis* each involving relatively small amounts. The banking Commission is also not convinced that the Reserve Bank should allow a certain quantum of refinancing to commercial banks against *hundis* discounted for the indigenous bankers. At present the volume of this business is not so large as to warrant separate refinancing facilities and the refinancing requirements of commercial banks can easily be met from the facilities that are customarily given to them. In other words, the Reserve Bank could delegate a certain quantum of refinancing responsibility to commercial banks only if the volume of business reaches significant proportions. Some understanding should be reached between the commercial banks and the indigenous bankers regarding the level of interest rates that such bankers should charge on advances to their customers. It should be made incumbent on commercial banks to see that no indigenous banker availing himself of bank credit facilities charges interest rates higher than those agreed upon. The Reserve Bank should periodically indicate the interest spread considered adequate for this business. Where the commercial banks are satisfied that lending by the indigenous bankers is for priority sectors they should charge a reasonable discount rate and also ensure that the indigenous bankers pass on the benefit to the borrowers. A code of conduct should be formulated for the operations of indigenous bankers. Indigenous bankers found to be indulging in malpractices should not be allowed any further bank accommodation. Pending the constitutional amendment, a model legislation should be drafted for adoption by all States to regulate the activities of those indigenous bankers who rely entirely on bank credit as an external source of finance for the conduct of their business. The legislation should impose penalties for charges in excess of the standardised ones or for failure to disclose the full terms to the customer. In cases of flagrant violation, the authorities should have the power to suspend the licences of indigenous bankers.

A systematic evaluation of the financial statements of indigenous bankers should be undertaken by commercial banks. Commercial banks should also satisfy themselves, at least on a random check basis, that the credit has been

used for the purpose for which it was given. Once the present approach of commercial banks to credit analysis of indigenous *hundi* business is replaced by a systematic credit analysis, the flow of assistance from commercial banks to the indigenous bankers should be steady and uninterrupted. The object[37] of Section 24 of the Banking Regulation Act would suffer if *multani* bills discounted by scheduled banks are accorded the status of 'liquid assets' under that Section. It may be desirable gradually to raise the maximum value of a *multani hundi* from Rs 5,000 to Rs 10,000 and in the case of creditworthy borrowers up to Rs 25,000 to facilitate increasing amounts of indigenous banking funds being channeled to meet the working capital requirements of small-scale industries. The provisions of the Negotiable Instruments Act, 1881, as such do not apply to *hundis*. It is necessary to codify the practices and usages applicable to such indigenous negotiable instruments and bring these instruments within the framework of codified law. Standard forms of *darshani* (sight) and *muddati* (usance) types of *hundis* should also be drawn up. It is suggested that payments by a *darshani hundi* may be recognised as an eligible mode of payment under Section 40A(3) of the Income Tax Act.[38]

Indigneous bankers perform a useful role. They make credit available to those sectors which are productive but which are generally not catered to by commercial banks either on grounds of cost or the risks involved. Their methods of operation are expeditious and flexible. The *multani* shroffs provide to commercial banks a useful money market instrument possessing a high degree of liquidity and yielding a good return. At the same time, there is ample scope for abuse of the system, in particular the high rates charged for credit given by indigenous bankers. With the type of regulation and control contemplated the utility of these agencies to the economy can be considerably enhanced. Although commercial banks are expected to give greater attention to satisfy the needs of small borrowers of various types than in the past, it is unlikely that they will be able to displace indigenous bankers altogether. A more useful course would be to adopt measures so that these agencies work in conformity with the overall credit policy.

In the context of planning and developmental programmes the indigenous bankers would have to grow in size, become more professional in operation and diversify their business to be of greater use to society. They would have to consider organisational changes such as conversion of partnership firms into corporate enterprises. Their growth should not be governed by the narrow objective of preserving the family unit of enterprise. Commercial banks, in their dealings with indigenous bankers, should encourage them to become corporate bodies. The future of indigenous banking seems to lie in linking it with the organised financial system by taking on some of the activities of ancillary nonbanking financial intermediaries such as dealing in short-term paper. As the economy grows sophisticated financial institutions would be required to meet the growing credit needs of the community, and discount and acceptance houses might

[37] The object is to ensure that a certain portion of deposit is made available for approved securities.

[38] For details see the Report of the Banking Commission, pp. 452, 463, and 628.

become necessary. With their banking acumen and traditional skills the more efficient of the indigenous bankers could transform themselves into discount and acceptance houses provided they adopt the corporate form of organisation.

XII

Provisions of the Directives Honoured More in Breach than in Observance

The question of greater 'social control' over banking operations by setting up another institution like the National Credit Council naturally leads one to the conclusion that in spite of extensive powers of control and regulation, both supervisory and monetary, vested in the Reserve Bank of India, it has not been able to direct bank funds to socially desirable fields. If, in spite of these extensive powers, it has not been able to utilise bank credit to promote desired social objectives, this can reasonably be attributed to the ineffectiveness of the measures of the central monetary authority or due to dubious operations of a certain section of banks.

That a considerable part of bank credit to the private sector goes to sustain speculative activities is admitted even in Reserve Bank Reports, though in rather guarded language. The Report for 1959[39] admitted that the high volume of commercial advances:

> would appear to have been more than warranted by the requirement of trade and might have been partly used for carrying excess inventories in certain lines.

The Repors for 1960[40] reiterated...

> "bank credit... appeared to be larger than was warranted by the genuine requirements of trade and industries. Prices began to move up... The stock market too was characterised by boom conditions, aided to some extent by a sharp rise in credit against equity share... "

It seems there is lack of efficiency in the inspection work of the Reserve Bank and it is unable to pinpoint the defects and irregularities of the commercial banks. It is also true that the authorities of the Reserve Bank have sometimes taken a long time to take a firm decision on the steps to be taken against a delinquent bank and that the application of its monetary-credit control measures has been either ill-timed or badly coordinated.

The two most important problems of monetary policy pertain to its timing and adequacy. The first problem relates to the various lags of monetary policy that are not typical to India. According to Milton Friedman,[41] these lags may be listed as follows:

(i) the lag between the occurrence of an event requiring policy change and its recognition by the authorities;

[39] Report of the Central Board of Directors for 1959, Reserve Bank of India.

[40] Report of the Central Board of Directors for 1960, Reserve Bank of India.

[41] Friedman, Milton, "A Monetary and Fiscal Framework for Economic Stability", *American Economic Review,* XXXVIII, No. 3, June 1948, pp. 245-64.

(ii) the lag between recognition of the need for a policy change and the formulation of new policies;
(iii) the lag between the formulation of a policy and its implementation on scheduled banks;
(iv) the lag between the impact of a new policy on banks and its realization in affecting changes in income and prices.

The main cause of the first lag is the delay in the collection and interpretation of statistical data and the time spent in working out its policy implications. This lag is likely to be longer in India than, in the USA for example, because of the relative insufficiency and unreliability of data in India. The second lag may be longer or shorter depending upon the efficiency of the administrative apparatus, or upon the general ease or difficulty in making a decision on new policies or changes in an existing policy. The third lag will depend upon the speed of communication between the Reserve Bank and scheduled banks. The fourth lag cannot even be guessed because in India income and prices are often subject to far more powerful influences than those emanating from banks.[42]

It is quite evident that the effectiveness of credit control policy will largely be derived from its proper timing. Proper timing can thwart a speculative boom from developing, slow down an increase in prices through selective controls or make the economic system more or less stable by influencing expectations one way or the other.

There has been much vacillation by the Reserve Bank in taking appropriate action against inert and delinquent banks. In order to implement credit control policy effectively, the central bank must be endowed with adequate facts and statistics before it can issue a directive which would be purposive and timely. For prompt, effective and continuous control over the banking system, the Reserve Bank of India must, as a matter of regular practice, have full knowledge of the material facts of the market, it must know the correct position of the portfolio of a bank and have accurate and definite information of banking conditions. It must be equipped with adequate authority to ensure that it is furnished with such statements and information of banks' business as required.[43] Such regulatory powers may prove to be of immense help to the central banking authorities in exercising banking control. Unless it possesses full and adequate information about the portfolio of a particular bank, it may find it difficult to come to the aid of the latter in case of need. By the time a bank in need gets in touch with the central bank and the latter secures the necessary information, the situation may get out of control with disastrous consequences both for the bank and the economy as a whole. Such cases occurred in India, once in 1938[44] and again in 1960, when three of the important South Indian banks fell into

[42] Johri, C. K., *Monetary Policy in a Developing Economy*, The World Press Ltd., Calcutta, 1965, Chapter IX.

[43] Report of the Central Bank of Argentina for 1939, p. 6, Reg. 10 of the National Security (Wartime Banking Control) Regulations of 1941, Australia. A recommendation to grant statutory powers to the Commonwealth Bank of Australia was made by the Royal Commission on the Monetary and Banking System in Australia, p. 237, para 619.

[44] *Report on Currency & Finance*, Reserve Bank of India, 1938-39.

difficulty and had to close their doors before the Reserve Bank could come to their rescue. Prompt Reserve Bank action was prevented by the fact that it had no information about the correct position of the banks. The proper time to satisfy itself on the general position of the banks was not when they lay gasping for breath,[45] but earlier to prevent such a condition.

The second problem of monetary policy is to determine the degree of restraint or ease to be applied whenever policy adjustments are needed. In this respect the experience of a central banker counts for much. This is very true of the Reserve Bank of India which was relatively inexperienced and a novice in co-ordinating credit policy with the requirements of a development Plan.

In respect of selective credit control, there is ample evidence to show that compliance on the part of the commercial banks with the Reserve Bank of India's directive has not been completed. Experience shows that certain commercial banks circumvented the weapons of credit control of the Reserve Bank. For example, in the implementation of selective credit control measures, there was virtually no compliance with many central bank directives by the commercial banks. In some cases, there has been only partial compliance. Again, on many occasions, many banks, including the State Bank of India, have not complied with the provisions relating to reduction of the total advances to prescribed limits. Thus, the provisions of the directives of the Reserve Bank of India were honoured more in breach than in observance, and herein lies the problem of the effective functioning of credit control. Dr. Sen[46] admirably sums up this phenomenon when he says of the Reserve Bank that

> Its aim was no doubt to restrain these particular uses of bank credit. But its bite was never deep enough to hurt. Underdeveloped economies are also characterised by underdeveloped law-abiding habits.

There would have been much better compliance if the Reserve Bank had threatened to withdraw rediscounting facilities from the offending banks.

Scrupulous observance of obligations on both sides will be necessary to respond to the new set of circumstances, needs and urges. A central bank must endeavour to enlarge the areas of participation, consultation and discussion with the banks. This is a challenge for both the Reserve Bank and the banking units working under its general superintendence—a challenge well-worth accepting by the banks in devising means to satisfy the growing needs of the nation and by the central bank in adjusting its regulatory methods from time to time, in its endeavour to ensure the essential soundness of the banking system. The central bank will have to fashion appropriate tools for the new task, redefine tasks and priorities and refine programmes and methods conducive to economic growth and stability. With continuous understanding and cooperation between the Reserve Bank of India and the commercial banks and also with better compliance with central banking directives by the latter, the task imposed on the central bank of regulating the banking system for economic progress and stability can be better accomplished.

[45] Muranjan, S. K., *Modern Banking in India*, Popular, Bombay, 1952, p. 286.
[46] Dr Sen, op. cit., p. 210.

XIII

Observations

Regulation loses much of its significance in the absence of efficient administrative machinery for its implementation. Hence, it is necessary to have adequate machinery for administering the scheme of banking regulations. The question is whether the administrative authority for the control and regulation of all banking institutions—commercial, cooperative, indigenous and development—should be vested in the hands of the Reserve Bank of India. Banking regulation has not been effectively applied to financing institutions which are 'companies' though the Banking Regulation Act, 1949, extends to them. The Study Group constituted by the Banking Commission to review the laws concerning and affecting banking have recommended that while the jurisdiction to implement the regulation of commercial banks, etc., may have to lie with the Reserve Bank, the administration of the regulation provided for other financing institutions and deposit-receiving institutions should be left to a separate decentralised agency which should work in close association with the Reserve Bank. A separate licensing or regulating authority entrusted with statutory powers to administer the provisions of the banking regulation applicable to financing institutions and deposit receiving institutions seems to be superfluous in the existing circumstances. Lack of coordination between the Reserve Bank and such an apex body may jeopardise the interest of both borrowers and investors and may cause dislocation in administering discipline in the money market and capital market. Hence the Reserve Bank itself should be vested with such responsibility which it could discharge departmentally and by opening branches in all the States.

Given this approch it would be wise for the Reserve Bank to consider a fundamental revamping and reexamination of its regulatory framework in the light of new realities. The broad objectives of this regulation would be first, to promote sound and viable banking institutions offering safety to depositors and continuing financial services to their customers and communities; second, to prevent undue concentration of banking powers principally through geographical limitations on banking facilities and the encouragement of a large number of banks; and third, to maintain a separation of banking from commerce in order to promote soundness in banking and to prevent economic power from being concentrated in the banking industry.[47]

[47] For an excellent analysis see "The Growth of US Banking Abroad" by Brimmer and Dahl in the *Journal of Finance*, May 1975.

Annexure 12.i

Particulars in respect of Amalgamation and Transfer of Liabilities and Assets of Banking Companies during the Period July 1973 to June 1974

Name of the bank	*No. of offices*	*Name of the transferee bank*	*Date of amalgamation or transfer*
(1)	(2)	(3)	(4)
I. List of banks amalgamated under Section 44(A) of the B.R. Act, 1949,	—	—	—
II. List of banks which have transferred their liabilities and assets to other banks.			
Hindusthan Mercantile Bank Ltd.	6	United Bank of India	With effect from Dec. 22, 1973
III. List of banks whose business has been acquired by the State Bank of India under Section 35 of the State Bank of India Act, 1955, or by its subsidiaries under Section 38 of the State Bank of India (Subsidiary Banks) Act, 1959.			
Krishnaram Baldeo Bank Ltd.	8	State Bank of India	With effect from April 19, 1974

Annexure 12.ii

Statement showing the Position in Regard to Licensing in Terms of Section 23 of the Banking Regulation Act, 1949, during July 1973 to June 1974

No. of li.ences issued for opening new offices	*No. of licences issued for opening temporary/seasonal offices*	*No. of licences issued for changing locations of existing offices*	*Total number of licences issued*
1,767	4	2	1,773

Annexure 12.iii

BANKING CODE

(Deals with Concerns Accepting Deposits from the Public)

- INSTITUTIONS AUTHORISED TO ACCEPT CHEQUEABLE DEPOSITS, i.e. 'BANKS'
  - Nationalised banks
  - Cooperative banks
  - Rural banks
  - Other banks
- PERSONS AUTHORISED TO ACCEPT ONLY NON-CHEQUEABLE DEPOSITS
  - For their lending or investment activities, i.e. financing institutions
    - Corporate bodies
    - Firms and individuals[1]
      - Loaning concerns[2]
      - Hire-purchase financing concerns
      - Housing finance institutions
      - Investment concerns
  - For merely financing their own business such as manufacture or trade, i.e. deposit receiving institutions
    - Companies
    - Firms and individuals

[1] This category would include persons who may be described as 'private bankers'.

[2] This includes *Nidhis* which do not accept demand deposits.

Source: *Report of the Banking Commission*, p. 479.

13

Bank Nationalisation and Central Banking Policy

Assessment of the Performance of the Public Sector Banks

The primary objectives of bank nationlisation were to extend banking facilities to unbanked and underbanked areas, especially in rural areas, to ensure an increased flow of assistance to the hitherto neglected sectors, to foster the growth of new and progressive enterpreneurs, and to give a professional bent to bank management with a view to removing control by a few. There has been considerable expansion in the geographical and functional coverage of commercial banks' operations with massive branch expansion and large scale deposit mobilisation. The greatest achievement, however, is the extension of banking to the rural, unbanked, and less developed areas along with a shift in emphasis to priority sector lending. A wide geographical area has been covered and a significant decline in the population served by each bank office has been achieved.

From a meagre Rs 909 crores in December 1951 at the commencement of First Plan, deposits have risen to Rs 10,635 crores at the end of June 1974—a twelvefold increase. The number of branches inreased from 4,151 at the end of 1951 to 8,262 by June 1969 on the eve of nationalisation. While it took eighteen years for the number to double itself, it took only five years after nationalisation to redouble this figure to 16,936.

A comparative study of the private and public sector banks is interesting. It will be observed that there is no material alteration in the central banking policy regarding the distribution of banking facilities between private and public sector banks during the six-year period of nationalisation. At the time of nationalisation public sector banks together accounted for 83 per cent of credit and 84 per cent of deposit. The share of the public sector banks in respect of bank offices also remained unchanged at 80 to 81 per cent. During the six-year period of nationalisation the percentage increase in the number of offices of private sector banks was as much as 123 compared to 110 of the public sector banks. Thus private sector banks have valiantly kept pace with

the public sector banks, despite the obvious advantages by way of central banking patronage and Government prestige enjoyed by the public sector banks and the constraints under which the private sector banks are obliged to operate. The pace at which the public sector banks expanded their branch network has been without a parallel anywhere in the world (Tables 13.1, 13.2, 13.3 and 13.4).

TABLE 13.1. Structure of Indian Banking

(Amount in crores of rupees)

	End of June 1969				*End of June 1974*			
	Number of banks	*Number of offices in India*	*Aggregate deposits*	*Advances (including bills)*	*Number of banks*	*Number of offices in India*	*Aggregate deposits*	*Advances (including bills)**
1. Nationalised Sector								
A. State Bank of India and its subsidiaries	8	2,462 (30.6)	1,239 (26.6)	1,185 (33.0)	8	4,724 (28.1)	3,007 (28.3)	1,875 (29.8)
B. Banks nationalised on July 19, 1969	14	4,133 (51.4)	2,633 (56.7)	1,832 (50.8)	14	9,017 (53.6)	5,927 (55.7)	3,459 (54.9)
Total for 1(A+B)	22	6,595 (82.0)	3,872 (83.3)	3,017 (83.8)	22	13,741 (81.7)	8,934 (84.0)	5,334 (84.7)
2. Non-nationalised sector								
C. Other Indian scheduled commercial banks	36	1,320 (16.4)	297 (6.4)	197 (5.5)	39	2,943 (17.5)	NA	NA
D. Foreign banks	15	130 (1.6)	477 (10.3)	385 (10.7)	13	130 (0.8)	NA	NA
Total for 2(C+D)	51	1,450 (18.0)	774 (16.7)	582 (16.2)	52	3,073 (18.3)	1,701 (16.0)	965 (15.3)
All Scheduled commercial banks (1+2)	73	8,045 (100.0)	4,646 (100.0)	3,599 (100.0)	74	16,814 (100.0)	10,635 (100.0)	6,299 (100.0)

Note: *Figures within brackets indicate percentage to total.
Refer to June 30, 1973. NA = Break-up not available.

While the progress made by the public sector banks in branch expansion during the last six years is gratifying, the leeway yet to be made up in removing wide disparities in the regional spread of banking facilities is considerable. The need for extending bank branches to the relatively backward areas is particularly urgent.

One of the important objectives of bank nationalisation was the reduction

TABLE 13.2. Branches of Public Sector Banks

At the end of	*No. of branches*	*Increase over the preceding year* — *Total*	*Increase over the preceding year* — *In rural areas*	*New branches opened in rural areas as per cent of total new branches opened*
June 1969	6,595	—	—	—
June 1970	8,253	1,658	1,093	66
June 1971	9,887	1.634	1,084	66
June 1972	11,147	1,260	358	28
June 1973	12,539	1,392	608	44
June 1974	13,741	1,202	452	38
Total		7,146	3,595	50

TABLE 13.3. Centrewise Distribution of Public Sector Bank Branches

	Number of branches as at the end of			
	June 1969		*June 1974*	
	Number	*Per cent*	*Number*	*Per cent*
Rural	1,504	23	5,099	37
Semiurban	2,623	40	4,053	30
Urban	1,171	18	2,349	17
Metropolitan/Port towns	1,297	19	2,240	16
Total	6,595	100	13,741	100

in regional disparities. But the expansion of banking operations since nationalisation has, on the whole, followed and not influenced regional pattern development. The 'pull' factor of growth in agricultural incomes appears to have drawn banks to certain states—Punjab, Haryana, Andhra and Karnataka.

Another striking feature is the heavy concentration of credit in relatively developed states like Maharashtra, Tamil Nadu, Gujarat and West Bengal which accounted for more than 50 per cent of the whole outstanding credit to small industries and priority sectors in 1972. Again, the urban orientation of the banking system is evident from the fact that the five major cities with a population of over a million—Ahmedabad, Bombay, Calcutta, Delhi and Madras—have a major share in bank deposit and credit.

Statewise analysis indicates that within a State there is a high degree of concentration of credit in cities with a population of more than one lakh. For example, Bombay, Calcutta, and Madras account for respectively 85, 95 and 55 per cent of total credit available for the respective States. This suggests that commercial banks have not succeeded in reducing regional disparities. Branch expansion is, of course, a necessary condition for banking development. But equally important is the development of credit potential in the areas concerned so that the credit scheme acts as an effective instrument of growth.

TABLE 13.4. Centrewise and Bank-groupwise Distribution of Commercial Bank Branches

	State Bank of India	*State Bank of India subsidiaries*	*Fourteen nationalised banks*	*All public sector banks (1+2+3)*	*Other commercial banks*	*Total (4+5)*
	(1)	(2)	(3)	(4)	(5)	(6)
Rural						
June 1969	462	356	686	1,504	328	1,832
	(29)	(40)	(17)	(23)	(20)	(22)
June 1974	1,167	737	3,195	5,099	1,066	6,165
	(38)	(45)	(35)	(37)	(33)	(37)
Semiurban						
June 1969	795	377	1,451	2,623	699	3,322
	(51)	(42)	(35)	(40)	(42)	(40)
June 1974	1,124	566	2,363	4,053	1,036	5,089
	(37)	(34)	(27)	(30)	(33)	(30)
Urban						
June 1969	162	85	924	1,171	276	1,447
	(10)	(10)	(22)	(18)	(16)	(18)
June 1974	437	189	1,723	2,349	550	2,899
	(14)	(11)	(19)	(17)	(17)	(17)
Metropolitan/ Port towns						
June 1969	150	75	1,072	1,297	364	1,661
	(10)	(8)	(26)	(19)	(22)	(20)
June 1974	344	160	1,736	2,240	543	2,783
	(11)	(10)	(19)	(16)	(17)	(16)
Total						
June 1969	1,569	893	4,133	6,595	1,667	8,262
	(100)	(100)	(100)	(100)	(100)	(100)
June 1974	3,022	1,652	9,017	13,741	3,195	1,6936
	(100)	(100)	(100)	(100)	(100)	(100)

Note: Figures in brackets indicate percentages to total branches of the respective bank groups. The classification is based on 1971 census. Rural centres: population up to 10,000. Semiurban centres: population over 10,000 and up to 100,000. Urban centres: population over 100,000 and up to 1,000,000. Metropolitan centres: population over 1,000,000.

The fifth year of bank nationalisation was a year of crisis. There was a considerable slowing down in commercial banking activities. An analysis of the working results of the 22 public sector banks reveals that their profits of Rs 12.3 crores during 1973 recorded a marginal improvement of Rs 0.4 crores over the previous year, as against a decline of Rs 0.8 crores in 1972. The profits of the public sector banks comprising the State Bank group and the 14 nationalised banks increased from Rs. 12.3 crores in 1973 to Rs 15.6 crores in 1974, but the rate of increase in the profits of foreign banks and the private Indian banks rose even more sharply.

According to figures published by the Reserve Bank of India, against the

increase of about 27 per cent in the profits of public sector banks, the foreign banks earned a profit, after provision for taxation and bonus to staff, of Rs 6.29 crores for 1974—a 49.8 per cent increase over the profit in 1973 of Rs 4.20 crores.

Twenty-five private Indian scheduled commercial banks with deposits of Rs 10 crores each increased their profits from Rs 1.38 crores in 1973 to Rs 2.90 crores in 1974—an increase of more than 110 per cent.

Of the public sector banks, the net profits of the State Bank group showed a nominal rise of Rs 57 lakhs whereas the profits of the 14 nationalised banks recorded a rise of Rs 2.9 crores over the previous year. The sixth year has been described as a year of consolidation—the banking system finding further progress more difficult. Some of the smaller private sector banks appear to have done much better than the public sector banks in deposit mobilisation. Their success could be attributed, mainly, to the speed and the manner of the adjustment of their behaviour patterns to the needs of their new clientele. Crisis in management is now considered a serious constraint on further expansion. There has been a sharp decline in the profitability of the banking system. Deterioration in industrial relations is also a serious weakness. Bank management has tended to buy industrial peace at considerable cost to depositors and borrowers. There is a wide spread between lending and deposit rates. The efficiency of any banking system can be judged by the spread of interest rates and Indian banks come out very poorly in relation to others on this count. The concept of the spread between the interest earned and interest paid by the banks is important. The spread or difference is the net amount available to the banks for meeting their operating, administrative, and management expenses. It is the amount of this spread and the trend of movements in the spread that is significant for the banks. The various expenses of banks should therefore be explained as a proportion of the spread (Table 13.7). The management crisis can also be seen in the noticeable deterioration in customer service. The banking industry is a high wage island in a sea of poverty and public criticism specially against the poor quality of service offered by the banks is mounting. This vital and human aspect is being ignored to the detriment of the interests of the banking industry and society. There is an inexcusable breakdown of communications between the Reserve Bank of India and the commercial banks on the vital question of credit squeeze. Moreover, nationalised banks are guilty of the deliberate violations of Reserve Bank credit policies.

II

Establishment of Rural Banks

The results revealed in Tables 13.5 and 13.6 on the performance of the public sector banks are not encouraging. In fact, in 1974, rate of deposit expansion and advances to priority sector slowed down. The Ordinance on rural banks (recommended by the Banking Commission in 1972 and five of

TABLE 13.5. Increase in Advances to Priority Sectors by Public Sector Banks

(Amount in crores of rupees)

Sector	*Variation during the year ended*				*Variation between June 1969 and Dec., 1973*	
	Dec. 1970	*Dec. 1971*	*Dec. 1972*	*Dec. 1973*	*Absolute*	*Percentage share*
1. Agriculture						
(i) Direct finance (excluding plantations)	111	16	41	100	329	30
(ii) Indirect finance	17	−23	41	18	56	5
2. Small-scale industries	110	62	87	199	521	47
3. Road transport operators	22	8	9	24	74	7
4. Retail trade & small business	35	6	9	29	97	9
5. Professional & self-employed persons	6	2	5	13	26	2
6. Education	2	1	−1	1	3	Neg.
Total (1-6)	303	72	191	384	1,106	100
Increase in advances to priority sectors as per cent of increase in total advances	42	18	42	NA		NA

Note: NA = not available.

which have been set up) constitutes a major step towards revitalising rural India on the basis of social justice. Measures initiated by the Government to liquidate rural indebtedness in the wake of the Emergency promulgation have dried up the traditional sources of credit on which small and marginal farmers mainly depend. The rural banks are intended specially to serve these weaker sections on a basis different from that of the commercial and cooperative banks. The performance of the public sector banks in this field has fallen far short of expectation. Small farmers have not derived much benefit from their urban-oriented policy which is based on providing loans against solid security. Similarly the cooperative movement has come to be dominated by big farmers, the small holders and landless labourers being left in the lurch. This has only helped the exploitation of the poorer section and widened the gap between the rural haves and have-nots, and consequently intensified social tension. Rural India can only be stregthened in the real sense by creating subsidiary occupations. These rual banks will not seek to finance agricultural operations, only, but rural artisans and small entrepreneurs, too, will be brought under their fold as diversification of rural economy seems to be one of their principal objectives. Commercial and copperative banks are operating in the same field, though in a different way. A coordinated approach, on a well-planned basis, is, therefore, vital for the purpose. But to put the rural banks on par with cooperatives in respect of subsidised banks it will be necessary to amend the

TABLE 13.6. Advances by Public Sector Banks to Agriculture and Other Neglected Sectors

(Amounts outstanding at the end of period in crores of rupees)

	June 1969			Dec. 1970			Dec. 1972			Sept. 1973		
	State Bank group	*Fourteen nationalised banks*	*All public sector banks*	*State Bank group*	*Fourteen nationalised banks*	*All public sector banks*	*State Bank group*	*Fourteen nationalised banks*	*All public sector banks*	*State Bank group*	*Fourteen nationalised banks*	*All public sector banks*
1. Agriculture												
(i) Direct finance (excluding plantations)	11.06	26.96	38.02	74.67	127.16	201.83	75.03	194.65	269.68	95.00	237.00	332.00
	(0.93)	(1.47)	(1.26)	(5.63)	(5.31)	(5.42)	(4.50)	(6.20)	(5.62)	(5.31)	(6.88)	(6.34)
(ii) Indirect finance	88.85	33.48	122.33	82.48	59.74	142.22	64.68	95.21	159.89	58.00	111.00	169.00
	(7.50)	(1.83)	(4.05)	(6.22)	(2.49)	(3.82)	(3.88)	(3.03)	(3.33)	(3.24)	(3.22)	(3.23)
2. Small-scale industries	103.01	148.45	251.46	187.80	232.24	420.04	254.97	318.63	573.60	293.00	372.00	665.00
	(8.69)	(8.10)	(8.34)	(14.15)	(9.69)	(11.28)	(15.31)	(10.16)	(11.94)	(16.37)	(10.79)	(12.70)
3. Road transport operators	—	6.69	6.69	7.75	29.34	37.09	7.15	48.64	55.79	10.00	60.00	70.00
		(0.37)	(0.22)	(0.58)	(1.22)	(1.00)	(0.43)	(1.55)	(1.16)	(0.56)	(1.74)	(1.34)
4. Retail trade and small business	—	19.22	19.22	23.71	50.74	74.45	20.31	67.11	87.42	24.00	79.00	103.00
		(1.05)	(0.64)	(1.79)	(2.12)	(2.00)	(1.22)	(2.14)	(1.82)	(1.34)	(2.29)	(1.97)
5. Professional and self-employed persons	—	0.33	0.33	0.78	7.79	8.57	1.08	14.24	15.32	2.00	22.00	24.00
		(0.02)	(0.01)	(0.06)	(0.33)	(0.23)	(0.06)	(0.45)	(0.32)	(0.11)	(0.64)	(0.45)
6. Education	—	0.46	0.46	0.05	3.42	3.47	0.02	2.93	2.95	—	4.00	4.00
		(0.02)	(0.02)	(0.04)	(0.14)	(0.09)	(0.01)	(0.10)	(0.06)		(0.12)	(0.08)
Total (1-6)	202.92	235.58	438.50	377.24	510.43	887.67	423.24	741.41	1,164.65	482.00	885.00	1,367.00
	(17.12)	(12.86)	(14.54)	(28.43)	(21.30)	(23.84)	(25.41)	(23.63)	(24.25)	(26.93)	(25.68)	(26.11)
Total advances by these banks	1,185.16	1,831.60	3,016.76	1,327.09	2 395.99	3,723.08	1,665.78	3,137.11	4,802.89	1,790.00	3,446.00	5,236.00

Note : Figures within brackets indicate the percentage to total advances.
Figures may not add up to totals due to rounding off.

Reserve Bank Act. If worked properly, the rural banks are expected to remove a great social injustice.

III

Restructuring and Regulation of Public Sector Banks[1]

The nationalised banks should be reorganised soon into three all-India banks and six other banks each specialising in developing banking services in a broad region. The Banking Commission is not in favour of restructuring the banks on functional lines (i.e. one bank to collect savings, another to serve large and medium-scale industries and so on) as that would involve drastic changes in institutional structure which might disrupt economic activity without any commensurate advantage.

In recommending the restructuring of the nationalised banks, the Commission took into account the findings of a study on the relationship between the costs and size of a bank which revealed that the size of a bank measured in terms of deposits can be quite substantial before it begins to suffer from diseconomies of scale. The Commission has found that consideration of the need for widening the range of services as well as effective implementation of the country's monetary and credit policy argues in favour of a relatively large size of bank; nowadays the possible diseconomies of management associated with big units can be effectively countered with available management methods. Despite these advantages however, the Commission does not think it would be desirable to amalgamate all the 22 separate banks in the public sector (i.e. the State Bank, its seven subsidiaries and the 14 nationalised banks) into a monolithic organisation, as that would pose formidable problems of integration. Besides, the Commission feels that bank customers should have a reasonable choice in selecting their banks.

The proposed restructuring of the public sector banks should be such that a fair proportion of well-developed areas and backward areas are allotted amongst the constituent units. That is to say, there should be some measure of equalisation of both the nature and volume of banking business amongst the different units to be formed on restructuring. As far as possible, the units should be compact ones operating over areas that are geographically contiguous. The customer should generally have a choice of at least two or three banks, particularly in the larger centres of population. The organisational set-up of the restructured banks should provide for decentralisation of work at branch offices and the establishment of zonal offices for control and guidance of 200 to 300 branches, with delegation of discretionary powers to the zonal and divisional managers.

Noting the present trend abroad to discountinue the maintenance of secret reserves the Commission has recommended that to enable the public to have a correct and complete idea of the position of the state-owned banks

[1] Vide Report of the Banking Commission, Government of India, 1972.

through their published accounts, maintenance of secret reserves should be done away with. The reason that secret reserves may be required to meet unforeseen contingencies does not apply to the banks in the public sector. Since, however, it is not desirable to adopt a different practice with reference to other banks and cooperative banks, the Commission has recommended that the provision in the Banking Regulation Act relating to the balance sheet and profit and loss accounts of banks may be modified to ensure full disclosure by banks of their assets and liabilities.

The method of analysing the profitability of individual branches of banks should be so devised as to reflect the true and fair policies of the bank. The public sector banks, in particular, should adopt a practice in regard to transfer prices (i.e. prices charged notionally on funds transferred by the branch to the head office) designed to suit the needs of the times.

IV

Uniformity in the Administration of Public Sector Banks

The aim of regulation of public sector banks should be to eliminate the differences in the patterns of regulations that now govern the State Bank group and the 14 major banks nationalised in July 1969. Uniformity in dealing with the public sector banks has been recommended by the Banking Commission under the following six major headings :

(1) Ownership pattern
(2) Organisational set-up
(3) Forms of authorised business
(4) Accounts, audit, profit, reserves, etc.
(5) Powers of Central Government
(6) Other provisions.

Since the capital of all the nationalised banks is owned by the Central Government, there is no need to allow outside shareholdings to continue in the capital of the State Bank group. All public sector banks should act on business principles and in the public interest.

Provisions regarding chief executives of all public sector banks should be uniform. There should be one whole-time chairman and one whole-time chief executive and the two offices should never be combined. Both of them should be whole-time directors. This action is necessary, because there is some talk already of having different classes of nationalised banks with different types of top management provided in each case. It is absolutely essential that whole-time chairman should be concerned with policy planning and development and the whole-time chief executives should be concerned with operational responsibilities. All this is necessary in order to bring nationalised banks in line with the management and organisation of the State Bank of India.

The Boards of the State Bank group should have representatives of various categories which have now been represented on nationalised banks in order to bring the State Bank group Board of Directors in line with the Boards of the

nationalised banks. There are restrictions on the State Bank from entering into some forms of business (Sections 33 and 34 of the State Bank Act). These should be removed and all banks should be able to engage in similar types or forms of business. It should be provided that transfers of profit by nationalised banks to the Central Government should only be after adequate reserves have been built up (Section 17 of the Banking Regulation Act). The Integration and Development Fund for the State Bank group should be discontinued. The annual accounts of the nationalised banks are to be placed before Parliament for consideration and the provisions relating to audit should be uniform for all the nationalised banks. It is desirable to provide specifically for branch audit at the nationalised banks on the pattern of the provisions applicable to companies (Section 228 of the Companies Act, 1956).

Despite statutory declarations of secrecy, banks in the public sector should not be precluded from disclosing information relating to their affairs as distinct from the affairs of their customers. The obligation of banks to observe secrecy regarding the affairs of their customers should continue, but this should not prohibit banks from giving general information without revealing the identity of individual customers. The duty to observe secrecy should be subject to well-defined exceptions.

Where a bank forms a *bona fide* impression that its customer is engaged in antisocial or illegal activities, it should be a statutory obligation for it to disclose information relating to the affairs of the customers to the authorities in the public interest. There should be full and frank communication of credit information between banks and financial institutions. There must be statutory provision requiring banks to furnish credit information to a Central Agency. Independence of public sector banks should be ensured from Government interference. It is, therefore, necessary that all directions issued by the Government to public sector banks should be in writing.

The effective functioning of the banking system depends on rational laws which affect banks so that innovations and improvements in banking techniques and practices are not impeded as a result of legal obstacles. Special provision to give individual depositors the facility to nominate a person to draw the savings after their death exists in the USA. The Post Office Savings Banks rules, the Public Debt Act, 1944, and the Cooperative Societies Act have such special provisions. The decision of the Government to give nomination facility to individual depositors would relieve survivors of thousands of bank depositors from the present harassment of having to establish their succession rights. Elaborate legislation is also in the offing to enable banks to return the articles in safe custody with them to the nominees of the depositor. Express provision is expected to be made on the lines of the banking codes of the USA namely, the Pennsylvania Banking Code (1965) and the District of Columbia Code for the repayment by banks of deposits held in accounts opened in the names of more than one individual. Banks are expected to be permitted to make payment to the nominee or nominees unless restrained by a Court order. The aim is not to affect the right of third parties. In relation to mortgaged, immovable property a nominee would have the right to redeem the mortgage by

repaying the amount due to the bank. An amendment to the Transfer of Property Act should be made.

V

Entrustment of Currency Chest

Under the existing arrangement, surplus funds accumulating at the branches of nationalised banks are tendered either at the Reserve Bank of India or at the State Bank of India or its subsidiaries for credit of their principal account. Unless the nationalised banks have facilities for immediate transfer of funds, the surplus money remains idle with them involving loss of interest. Now, due to a large influx of cash at nationalised banks, the Reserve Bank and the State Bank find it difficult to accommodate all the surplus cash. The provision of a currency chest at nationalised banks, specially at metropolitan centres, will solve the problems inasmuch as by depositing surplus funds into the currency chest, they would get immediate credit in respect of the funds deposited and instead of drawing funds from Reserve Bank or the State Bank, they may withdraw funds from the currency chest.

The availability of a currency chest obviates the necessity of the physical transfer of cash at frequent intervals, as funds can be deposited in one chest and taken out at another. At present the currency chests are not permitted to accept or exchange cut or mutilated notes. The public and the banks will benefit much if the currency chest is authorised to accept and exchange such notes on behalf of the Reserve Bank. Thus the provision of a currency chest in nationalised banks will provide relief to banking authorities as well as to the Reserve Bank of India.[2]

VI

Observations

Encouragement given to the nationalised banks to defray small loans to the weaker sections of society so as to broadbase the process of development is a basic change in the character of control in the Reserve Bank of India. After nationalisation the incidence of fraud has increased and the matter should receive immediate attention from the Reserve Bank. Moreover, the repayment of loans and advances is unsatisfactory, this means erosion of capital in the banking system.

An attempt is being made to decentralise some of the functions (like deposit of income tax and other receipts on Government Account) from the Reserve Bank to other nationalised banks. In relation to the transactions of Central

[2] The Central Government has issued a notification No. F4(150)-Bc/69, dated June 11, 1970, directing that the Reserve Bank of India may appoint any Corporate specified in Column 2 of the First Schedule to the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970, as its Agent.

Government business, all the nationalised banks should be treated equally. Section 45 of the Reserve Bank of India Act, 1934, may be suitably amended to embody this principle. Statutory provision should be made so that the nationalised banks may be entursted with State Government business. The Reserve Bank of India could then concentrate more on central banking functions, and the public at large will benefit immensely because of this decentralisation; it could approach other nationalised banks for Government business, and since these banks are scattered all through the length and breadth of the country, the customers will find it easy to approach them.

If all the nationalised banks are to be given parity of status, it is necessary to place the nationalised banks for the purpose of intermediate central banking functions, such as those specified under the provisions of Sections 18 and 24 of the Banking Regulation Act, 1949, and Section 42 of the Reserve Bank of India Act, 1934, on par with the State Bank of India and its subsidiaries. In the matter of administration and management also, they should be treated at par and there should not be any sort of discrimination amongst different banks.

In the postnationalisation period there has been little change in the character of control of the Reserve Bank over the banking system. The Department of Banking in the Ministry of Finance of the Government of India, in the changed circumstances, is the policy-formulating body in the fields of money and banking and issues directives and guidelines to the public sector banks through the Reserve Bank of India, the central bank of the country. Hence, the Reserve Bank of India just implements the policy that percolates from the Department of Banking. The Central Department of Banking Operations and the Development and Credit Authorisation Department have thus become redundant. The independence of the Reserve Bank in the matter of taking decisions in monetary and credit affairs has virtually ceased and its position as an independent authority in monetary affairs has been usurped. This conflict of dual control has posed serious problem to the public sector banks. The appointment of Directors or Observers in the boards of the public sector banks may not be effective and useful in this peculiar situation. In fact there were reports that the Reserve Bank was in favour of winding up the Department of Banking which came between it and the Government without adequate responsibility of its own. If social objectives to be fulfilled by the public sector banks are to be determined by the Government, the policy formulation and decision-making powers and the implementation of the policy decision should rest in the hands of the guardian of the monetary system.

The poor and unsatisfactory recovery performance may be ascribed to the fact that bank officials, from top to bottom, are not imbued with the new objectives of banking. They do not feel that they work for the development of national economic efficiency and progress. Public sector banks should adopt an appropriate mix of strategy, innovation and policy in the mobilisation of deposits. It is unfortunate that deposit mobilisation (17 per cent) has not been able to keep pace with credit expansion (24 per cent). Finally, the old abuses to misutilise bank credit to corner shares and acquire control over companies still exist. The expectation that public sector banks would provide

finance for the Five Year Plans has not yet been fulfilled. The contribution of the banks to the Plan finance is practically negligible.

The nationalised banks are still unsuccessful in filling credit gaps in different sectors. Although banking philosophy in the postnationalisation era has changed, the grass roots level bank staff have not been imbued with the motivation and vision of bringing about a silent revolution in the countryside. It is a tragedy that even though bank staff are highly paid, they are virtually static and have failed to appreciate the new social objectives. They have failed in aggressively mobilising the savings of society and channeling them equitably into productive spheres in conformity with policy objectives and priorities. The improvement of the organisational base is the desideratum. All bank staff must accept this new challenge of growth and development. The banking system touches the lives of millions and they must be inspired by a larger social purpose, new responsibilities, and obligations in order to stimulate economic development with stability and social justice.

A very remarkable achievement of nationalisation is the shift from security-oriented lending to production-oriented lending. Perhaps, a new dimension in the nationalised banks' operations is the substantial credit that they are giving to projects of national importance. It is a well known truism that whenever any institutional mechanism is stretched too fast and over a wider area, its efficiency suffers and the quality of services tends to get diluted. The banking system was called upon to expand at a phenomenal rate since nationalisation and, naturally, it was not possible for banks to train all the existing as well as additional staff to the high level of expertise and to the desired degree of efficiency in such a short time. The problem was one of expanding the banking network and services at a fast rate and at the same time of maintaining the high quality of their services.

A banker in the postnationalisation era is not just a purveyor of funds, but an innovator of economic and social change in the community in which he operates. For this, the banker has to take a lot of initiative as well as risk, much larger than what he or his counterpart of yesteryear was accustomed to take. The new style banking imposes much larger responsibility on the banker, just when he is least adequately equipped for this difficult task. More onerous social responsibilities and obligations devolve on the central bank under emergency provisions to give a new approach to the character of control of the public sector banks.

What is more important for the implementation of the 20-point Economic Programme in the context of the promulgation of the Emergency is the improvement in the performance of the nationalised banks as the rate of progress of the overall economy largely depends on the efficiency with which public sector banks function.

In the evolution of the central banking policy for the next decade, the first step that should be taken is to redefine the priority sector concept. The present concept of the priority sector which covers agriculture, small industries, and export absolutely excludes in practice the poorest of the poor (40 per cent of a population of 600 million) who do not get enough to eat even when the

monsoon is good. When the monsoon fails, these 240 million people simply starve. The priority sector at present includes small enterpreneurs, the real income of many of whom would be more than the combined incomes of the chairman and the managing director of some of the nationalised banks in India. But it is the rural poor—those neglected citizens whose family income does not exceed Rs 5000 a year—who should be the almost exclusive concern of the priority sector. In the matter of economic activity the priority sector should include those who are engaged, or may be induced to engage in, the production of food for human beings, fodder for animals, and fibre for clothing and other purposes. If bank credit could connect these idle manpower resources with untapped natural resources (food including milk, fish and poultry products, cattle-feed and fibre) in these basic activities, it would discharge real social duties. It is here that the impact of central banking policy on the quality of life of the neglected citizens will be visibly and decisively made. If cattle die in times of famine or drought, the bankers feel that it does not fall within their area of responsibility. They must realise that in economic terms cattle are as much a capital asset as a factory. It is therefore suggested that so long as the Indian economy is dependent on the vagaries of the monsoon, calamities such as famine, drought, and floods should be included in the concept of priority sector. The priority sector should also concern itself with the nonfactory decentralised sector which hardly gets one hundredth of what the factory sector gets (Rs 3,500) by way of bank credit. The aim of central banking policy should, therefore, be to uplift the underprivileged class of society in rural India from subsistence existence to surplus existence. Central banking expertise and compassion should be expressed in terms of lifting the poor from the animal existence to the human existence. Herein lies the *summum bonum* of the philosophy of responsibilities and obligations of the Reserve Bank towards the society in the context of bank nationalisation.

Society is the home of business particularly the banking business. For if the town or city dies, other business may move, but the bank will go down with its community. The relationship between a bank and its environment is symbiotic—it is a mutually beneficial relationship. Banking business or any other business—depends upon the different interest groups like Government, competitors, depositors, borrowers, employees, shareholders (in case of private sector banks), etc., that constitute its environment. These interest groups that are contributors to the bank's continuity and prosperity are also claimants of returns in different forms from the bank. Social awareness on the part of the banking business challenges the traditional concept of responsibility, and these social pressures are in effect a challenge to the thesis that decisions taken with a view to maximising private benefits maximise public benefits as well. There can be little doubt that central bankers, as well as the commercial bankers, will be "in the forefront of the continuing effort to make our society more humane as well as more abundant, more concerned as well as more efficient".[3]

[3] Prochnow & Prochnow, Jr., Ed., *The Changing World of Banking*, Harper & Row, New York, pp. 365-379.

TABLE 13.7. Comparative Statistical Analysis of the Performance of the Public Sector and Private Sector Banks as on Dec. 31, 1973

(Amount in lakhs of rupees)

Name of the Bank	*Balance of profits after usual & necessary provisions, taxation & bonus*	*Percentage of balance of profits to working funds*	*Percentage of balance of profits to total income*	*Percentage of balance of profits to spread*	*Percentage of balance of profits to spread and other earnings*	*Percentage of balance of profits to capital & reserves*	*Percentage of balance of profits to deposits*	*Percentage of balance of profits to establishment expenses*
1	2	3	4	5	6	7	8	9
1. State Bank of India	411.95	0.16	1.99	5.20	3.51	14.96	0.16	4.59
2. Total of 7 subsidiaries of State Bank of India	53.36	0.08	0.91	2.62	1.71	5.78	0.08	2.18
3. Total of State Bank Group (1+2)	465.31	0.14	1.75	4.67	3.13	12.66	0.14	4.07
3. (A) Total of 5 big Nationalised Banks	521.66	0.14	1.83	5.41	4.00	9.88	0.14	5.43
3. (B) Total of 9 Medium Nationalised Banks	241.38	0.09	1.18	3.17	2.40	8.00	0.09	3.29
Total of 14 Nationalised Banks (3A+3B)	763.04	0.12	1.56	4.43	3.30	9.20	0.12	4.50
Total of 22 Public Sector Banks (1+2+3A+3B)	1,228.35	0.13	1.63	4.52	3.24	10.26	0.13	4.33
Total of 20 small Indian Banks	25.66	0.15	1.67	4.69	3.46	6.01	0.15	4.76
Total of 14 Indian Medium Banks	101.66	0.15	1.85	5.18	3.82	10.27	0.15	5.45
Total of 11 Foreign Banks	420.27	0.52	5.55	14.83	9.31	45.78	0.52	22.63
Total of 45 Private Sector Banks	547.59	0.33	3.75	10.25	6.92	23.46	0.33	12.85
Total of 67 Banks	1,775.94	0.16	1.97	5.46	3.87	12.41	0.16	5.44

Annexure 13.i

Proposed Internal Organisation of Nationalised Banks
Head Office

Planning and development departments	*Specialised departments*	*Operational departments*	*Central departments*
1. Budgeting and profit planning	1. Management development	1. Investments	1. Inspection and audit
2. Economic research and statistics	2. Public relations	2. Central accounts	2. Scrutiny of periodical returns
3. Business development	3. Organisation and methods	3. Stationery	
	4. Advance to large and medium-scale industries	4. Establishment	
	5. Advances to small-scale industries	5. Premises	
	6. Advances to agriculture	6. Inter-branch accounts	
	7. Advances to small borrowers	7. Secretarial & board matters	
	8. Foreign exchange business	8. Sanction of Large Advances, etc.	
	9. Legal department, etc.		

(Contd.)

ANNEXURE 13.1 (*Contd.*)

Zonal Offices

(Controlling 200 to 300 Branches)

Functional department,	*Operational department*
1. Budgeting and profit planning 2. Economics and statistics 3. Business development 4. Management development 5. Public relations 6. Advances to large and medium-scale industries 7. Advances to small-scale industries 8. Advances to agriculture 9. Advances to small borrowers 10. Foreign exchange business, etc.	Department divided on terroitorial basis into divisions headed by Divisional Managers each of whom will be in charge of about 50 branches. The divisions will (i) handle sanction of advances in excess of powers vested in Branch Managers, (ii) attend to establishment and other matters emanating from branches in the division, and (iii) maintain field staff for periodical visits to branches.

Branch Office

Departments

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Deposits	*Advances to large & medium size industries*	*Advances to small scale industries*	*Advances to agriculture*	*Advances to small borrowers*	*Foreign exchange business*	*Collection*	*Remittances*	*Safe deposit vaults*	*Advisory services*	*Government business*	*Cash*	*Clearing*	*Accounts, etc.*

Note : 1. Departments will be headed by Officer-in-Charge suitably designated.
2. Number of departments in each branch will depend upon the range of activities and volume of business.

Source : Report of the Banking Commission, Government of India, 1972, p. 597.

PART THREE

Political Role

14

The New Philosophy of the Central Bank's Relationship with the Public and the Government*

Politics Determining Economic Policy Decisions and Priorities

The objectives of economic development, the ends towards which a nation strives are indeed a matter of political rather than economic decision. In major economic decisions, judgement is basically political and planners and economists must ultimately bow to political judgement. All that they can do is to draw attention to the implications of the judgement and analyse the criteria on which it is based. The nationalisation of the commercial banking system, for instance, is a vital economic issue today.[1] Here although economic analysis can point out pertinent considerations, the final judgement must be political. No less an authority than Professor Sayers has admitted that the question whether the banking system in a country should be nationalised or not is a matter to be decided by the politicians and not by the economists. It is often argued in India that the cost of particular services or supplies should be cheap in order to benefit the consumer—the person who particularly deserves such consideration. Here, again, judgement is political in character. Even the estimation of national resources is not a purely economic exercise. To a large extent, this also entails political judgement. In the simplest terms, the mobilisation of savings implies a degree of self-denial for the present so that the position in the future is eased. However, for people whose levels of

* The author gratefully records his deep sense of indebtedness to Professor Richard H. Timberlake, Jr., of the University of Georgia (USA), who has kindly spared so much of his valuable time in explaining by mail all the intricate issues analysed in this chapter. In fact, this chapter has gained much from his gracious letters dated June 4 and September 24, 1969, to the author.

[1] Fourteen major commercial banks in India were nationalised in July 1969.

consumption are already pitifully low, self-denial often amounts to self-torture. What sacrifices people will make today in order that they may have a better tomorrow is a matter for sociologists and politicians rather than economists. A great deal depends upon the level of public education in the widest sense of the term—upon the degree of understanding and identification which people have with the developmental effort. To what extent do the people at large see the link between the benefits which they expect and want and the price they are called upon to pay for them; to what extent do people in various walks of life—industrialists and workers, teachers and clerks—accept the rates of taxation as something conducive to their welfare and development—all these matters depend on the level of education. Up to a point the kind of political system also has a bearing on this. A dictatorial regime can get away with many things because all that it has to worry about or guard against is a revolution. A democratic regime, on the other hand, is subject to a popular vote periodically and has much less freedom of manoeuvre.

II

The Changing Role of the Central Bank in Relation to the Public

A central bank is necessarily a political institution. It is set up by an act of the legislature, and it usually has some direct connection with the Government. For instance, the Governor and Deputy Governors of the Reserve Bank of India are appointed and the rest of the Directors in the Central Board are nominated by the Government. In any case, a contemporary central bank has control over the economy's money supply and this function cannot possibly be left in the hands of private persons who act under principles of self-interested individualism. *Ipso facto*, a central bank is a part of the political structure.[3]

The political role of the Reserve Bank is examined here critically in the light of its delicate relationship with the public and the Government. Traditionally, central bankers in the past had a marked hesitation to write a paper or a book, or deliver a lecture in public on policy matters. Their preference was for letting their acts speak for themselves. In other words, orthodox central bankers in their relations with the public have been known in the past to be "members of the silent service". In the USA, owing to the decentralised character of the banking system, publicity was necessary. The central bankers therefore developed a tradition of informing the public of the policies they were about to adopt. It would have been difficult to secure the cooperation of the thousands of independent unit banks without the central banker coming forward and explaining his views publicly. So, the central bankers in the USA have been writing and speaking more than their counterparts in the UK where, on the other hand, the banking system was characteristically centralised and the convention was to speak less and the central banker always maintained a certain discretion in his pronouncements. This was carried to such an extreme

[3] See Professor Timberlake Jr.'s letter dated September 24, 1969, to the author.

that one of the results was the production by the Bank of England of one of "the dullest central bank reports".[3]

But the old order changeth, yielding place to the new. It is now considered useful for the central bank "to explain, discuss and forecast," to secure the cooperation of the public in the formulation and implementation of central banking policies and objectives. Today, the central bank has dispelled that "silly air of mystery" which surrounded its operations in the past. The old concept of the central bank working under a mysterious veil of secrecy is a complete anachronism in the present-day socio-economic structure. The modern concept of freeing the central bank from the traditional atmosphere of secrecy and mystery under which it operated in the past is now widely accepted. As Professor Whittlesey[4] puts it:

> the cloud of secrecy that traditionally shrouds the thoughts and deeds of central bankers was pierced by a number of unconventional proposals from newer members of the Board—rather to the dismay, it has been told, of older colleagues in the system.

Attitudes of central bankers may vary as to the extent to which they will break silence; this will depend on the peculiar banking and financial structure of the country and the formal responsibilities imposed on them and the Government by statute or convention, but, there is no question of their maintaining absolute silence. It will depend upon the judgement of the central banker himself when he should speak out, and when he should keep silent, and how far he should go in each case. Lord Cobbold, when Governor of the Bank of England, was certainly not a "member of the silent service"—he never hesitated to speak to the public. The Annual Reports of the Bank of England no longer make the same dull reading as they did before. Again the Governors of the Reserve Bank of India during the 1950s and 1960s in the course of their writings and lectures never hesitated to throw light on the policy decisions taken by the Bank and to discuss the impact of the monetary-credit policy and Government's fiscal policy in the stimulation of the growth process. Mr H.V.R. Iengar, when Governor of the Reserve Bank, delivered numerous speeches before businessmen, bankers and academic economists and also wrote a well-known book.[5] At present when heavy doses of deficit financing are injected into the economy for promoting economic development, the responsibility of the central banker to maintain financial discipline so that economic growth can be achieved in an environment of a reasonable degree of stability is, indeed, great. It is the patriotic duty of the central banker to draw the attention of the political authorities publicly when recourse to deficit financing oversteps the 'safe limit' and to point out the dangers of adopting such large-scale deficit financing. It may be noted that the Governor of the State Bank of Pakistan never hesitated to make public references to the need for rationalising

[3] Sayers, R. S., *Central Banking after Bagehot*, Clarendon Press, Oxford, p. 44.

[4] Whittlesey, C. R., "Rules, Discretion and Central Bankers," in *Essays in Money and Banking in Honour of R. S. Sayers*, Ed., C. R. Whittlesey & J. S. G. Wilson, Clarendon Press, Oxford, 1968, p. 265.

[5] Iengar, H. V. R., *Monetary Policy and Economic Growth*, Vora & Co. Pvt. Ltd., Bombay, 1962.

expenditure to reduce the quantum of deficit financing with a view to stemming the spiralling forces of inflationary pressures.[6] During the last two decades and a half the approach of the central bank has shifted remarkably in favour of attempts to bring informed public opinion more and more into the central bank's way of thinking. It is now believed that when the central bank and the Government hold different views in regard to a particular policy matter, the two viewpoints should be presented to the public for the purpose of a proper assessment.

III

History of the Relationship Between the Central Bank and the Government

The history of the relationship between the central banks and the Government reflects the gradual rise and subsequent decline of the doctrine of *laissez-faire*. After the principles of *laissez-faire* philosophy had been applied to the economic sphere, they came to dominate several aspects of central banking until they pervaded the whole field by the middle of the nineteenth century. An inevitable corollary of the principles of *laissez-faire* was that if there was to be a central bank at all, it should be politically independent. The history of the Bank of England illustrates the growth of this faith and philosophy. The improvident ministries of the day courted the rich Old Lady of Threadneedle Street as much as the Lady herself sought their favours. The former were in quest of loans and the latter of advantages at the time of renewal of their charter. From these relationships between the Government and the central bank, certain incidents were carefully picked out to demonstrate an inherent incompetence of the Governments in the sphere of currency and credit control. This, it was argued, led to the inevitable conclusion that the central bank should be independent of Government.[7] This trend of thought continued to develop till the outbreak of World War I. In the years after the War this habit of thought gathered considerable force under the belief that the War had exhibited in extreme terms the dangers of Government control and Government direction of central banking.[8]

After the orgy of inflation indulged in by most belligerent Governments in the War and the immediate postwar years, a sharp reaction set in against Government control and Government management. The tide set strongly against granting the Government power to interfere with the functioning of a central bank. The exposition of conservative central banking theory has stressed this political independence of central banks as one of its primary tenets.[9] The concept of political independence of central banks came to be

[6] *The Journal of the Institute of Bankers*, Pakistan, January 1959, pp. 62-63.

[7] *American Economic Review Supplement*, March 1944, article by K. R. Bopp, p. 262.

[8] Willis, H. Parker, *Theory and Practice of Central Banking* with special reference to the Federal Reserve System, Harper & Bros., New York, 2nd edn., 1936, p. 178.

[9] Kisch and Elkin, *Central Banks*, 1932, pp. 2 and 27.

embodied in the Brussels Conference Resolution of 1920 which was to the effect that "banks, especially Banks of Issue, should be freed from political pressure and should be conducted solely on the lines of prudence". This concept of political independence of Banks of Issue was the central feature of the reconstruction schemes initiated by the League of Nations and was enshrined in the statutes of most of the central banks established at the time—in Austria, Hungary, Estonia, Greece, etc. The characters of the banks subsequently established in certain Central American Republics exhibit the operation of the same principle.[10] But the imposing facade of complete political independence that central banks in many parts of the world had so assiduously built up crumbled with the impact of the Great Depression. The fate of independent central banks was sealed and the myth fostered so carefully in the 1920s that finance and politics should be kept segregated in troublous times was shattered.[11]

The postdepression years witnessed an increasing trend towards Government ownership and Government control of central banks. This trend has been reflected in the central banking statutes relating to ownership of capital, participation in administration, and intervention in monetary policy.

The National Bank in Copenhagen originally founded as a State Bank in 1813 was changed into a private shareholders' bank in 1818 and functioned in this form, independently of the State, for more than 100 years. By the Law of April 7, 1936, it was nationalised and transformed into Denmark's National Bank.

The Reserve Bank of New Zealand is an outstanding example of a nationalised central bank, if not because of its subservience to the Government, at least because of the unequivocal way in which this has been laid down in the constitution.[12] When the Reserve Bank Bill was introduced for the first time in 1932, the proposed Bank was conceived on orthodox lines and, in accordance with Sir Otto Niemeyer's recommendations, was to be controlled by a Board "entirely free from the actual fact and fear of political interference." The Bank was established on August 1, 1934, as a private shareholder's bank by the Law of November 27, 1933, but important departures were made from Sir Otto's scheme as the Act made provisions for a substantial measure of political control. The Board of Directors came to be composed not only of four shareholders' directors but also of the Secretary to the Treasury, three State directors, the Governor and the Deputy Governor, all of whom were to be appointed by the Governor-General in Council. Although the Bank was established with wide Government powers over it, yet the monetary reformers were not satisfied. The Labour Government by passing an amending Act on April 8, 1936, placed the Bank virtually in the position of a Government department. The shares were cancelled and the holders were given, in exchange, Government stock or cash computed on the market valuation of the

[10] Basu, S. K., *Central Banking in the Emerging Countries*, Asia Publishing House, Calcutta, 1968, p. 68.

[11] Johnson, G. G., *The Treasury and Monetary Policy*, Harvard University Press, Cambridge, Mass., 1939, p. 6.

[12] Randerson, H. R., "The Reserve Bank of New Zealand", *The Bankers' Magazine*, April 1939, p. 580.

shares. Every vestige of private control was completely removed; the Secretary to the Treasury who did not previously possess a vote was given one; and the Board of Directors were to serve at the pleasure of the Government. All previous restrictions on the power of the Bank to buy and sell long-term Government securities were removed and the Bank was authorised to underwrite any New Zealand Government loan, advance the full amount of the Treasury's estimated revenue and discount Government bills.

The Bank of Canada was established in 1935 as an entirely private shareholders' bank. Under the Law of 23rd June, 1936, the State assumed partial ownership of the Bank by increasing its capital by issuing 102,000 shares of class B at par value of $ 50 each to the Minister of Finance.[13] By the Bank of Canada Amendment Act of July 1, 1938, which came into force on August 5, 1938, the Bank was nationalised. Section 17(1) of the Act provided that the capital of $ 5 million should be issued to the Minister to be held by him on behalf of the Dominion of Canada. Under Section 17A, the Minister was to exchange 100,000 Class B shares out of the 102,000 held by him for 100 shares of the capital of the Bank which it had been authorised to issue.[14]

When a new central bank was formed in Paraguay by the Decree of 23rd February, 1936, out of the existing Bank of the Republic of Paraguay, a private owned commercial bank, it was State owned.[15] By the Law of 12th March, 1936, the Bank of Italy was transformed into a "public law" institution and the private shareholders were repaid the old capital.

In Germany, although the old Reichsbank was privately owned, it was operated and controlled by the Government. This long association of Government control was broken by the Law of 1924. The new bank was created as a privately owned joint-stock company to be controlled by its own Board of Directors and the charter stressed its independence of State control.[16] But when the statutes of the Bank were amended by the Law of 10th February, 1937, the provisions regarding its independence were eliminated and its Directorium placed directly under the Fuhrer and Chancellor.[17] New law seeking to bring the transformation of the Reichsbank, which had begun with the Law of 10th February, 1937, to a conclusion in conformity with national socialist principles was promulgated on 15th June, 1939. Section 1(1) definitely laid down that the German Reichsbank should be responsible to the Fuhrer and Chancellor of the Reich.[18]

By 1948 as many as 36 out of 57 central banks of independent countries

[13] *Federal Reserve Bulletin*, October 1936, pp. 789–92. Sec. 17(1), The Bank of Canada Amendment Act, June 23rd, 1936: "The capital of the Bank shall be ten million one hundred thousand dollars consisting of one hundred thousand shares (Class A) issued to the public and one hundred and two thousand shares to be issued to the Minister at par (Class B) to be held by him on behalf of the Dominion of Canada and to be paid for out of the consolidated revenue funds."

[14] The Bank of Canada Amendment Act of 1st July, 1938, *Federal Reserve Bulletin*, August, 1938, pp. 652-54.

[15] De Kock, *Central Banking*, p. 284.

[16] Northrop, M. B., *Control Policies of the Reichsbank*, p. 29.

[17] *Sixth Annual Report of the Bank of International Settlements*, p. 95.

[18] *Federal Reserve Bulletin*, September 1939, pp. 734-742.

had been nationalised as against 10 completely Government-owned banks in 1931, 15 in 1939 and 19 in 1945. The most outstanding cases of nationalisation were those of the UK, France, India, Argentina, Romania, Yugoslavia, Czechoslovakia and the Netherlands. Not only did established central banks come to be nationalised but new central banks formed in the newly independent colonial countries have all been owned by their Governments. The entire share capital of the central banks in Burma, Ceylon, Ghana, Rhodesia, Nayasaland, the Malayan Federation, and Jamaica has been taken up by the Government of the respective countries. All the central banks in the newly independent colonies of Africa except that of Libya were from the start envisaged to be owned wholly by their respective Governments.

The statutes of the central banks of Nigeria, Ghana, Rhodesia, and Nayasaland though of British heritage, were in sharp contrast with those of the Bank of England or the Reserve Bank of India and do not contain any provisions empowering the Government to issue directions. The elaborate procedure for resolving any possible conflict between the Treasury and the central bank, which is to be witnessed in the case of certain countries in the Commonwealth, e.g. Australia and Ceylon, is also missing in the case of all those banks.

In the case of central banks of French heritage as those of Morocco and Tunisia, there is no legislation providing for Government intervention in any form whatsoever in the conduct of their business. Nor is there any provision empowering the Government to issue general policy directives to be complied with by the banks. The structural organisation of the banks in the newly 'emerging' countries of Africa has been considerably influenced by their heritage. In the case of banks having an English heritage such as Nigeria, Ghana, Rhodesia and Sudan, they incline to the Bank of England tradition in their administrative set-up.[19] The administrative organisation of banks with a French heritage has been modelled, more or less, on the lines of the Bank of France and has no Board of Directors standing between the General Council and the administrative organs.

Nationalisation of the old central banks has not, however, brought about a change in their legal status. This is particularly true of the historic case of the nationalised Bank of England. The powers under the Nationalisation Act had merely given statutory sanction to what had long existed by custom and tradition. It has simply brought into legal form what had for many years been the accepted practice and will "do no more than put the saddle on the right donkey's back". The catalogue of changes is really a catalogue of no changes and the Bank of 1946 does not differ significantly from the Bank of 1945.[20]

That the Act has merely provided legal confirmation of an existing factual position has been expressed in picturesque language by Dr Dalton. His Majesty's Government and the British people, he observed, felt that the time had come for the close and intimate relationship existing between the old Man of the Treasury and the old Lady of Threadneedle Street to receive the sanction of

[19] Basu, S. K., op. cit., Chapter V, pp. 67-76.
[20] *The Economist*, February 16, 1946, p. 259.

law; and the two parties should be joined in lawful wedlock lest anybody think of the danger of their living in sin. Thus nationalisation which has been used to describe the change in the legal status of the Bank of England and various other central banks may be the language of party politics but is really a misnomer.[21]

The trend towards the statutory definition of the position of a central bank *vis-à-vis* the Government is the outcome of complex forces—political, economic and ideological.[22] In Romania nationalisation was but one aspect of a new economic policy patterned after the USSR while in the UK it was a 'facet' of the general programme of the Labour Party which had just stepped into power. The advent of the socialist Government in Australia was similarly responsible for the nationalisation of the Commonwealth Bank. In countries with under-developed banking systems and state-directed economies, the doctrine of a private shareholders' type of central bank found no favour. In Paraguay and Guatemala nationalisation of central banking was but one aspect of the regime of extensive Government intervention. In many cases the traditional British model of 'independent' central banks proved unsuitable on native soil and withered away soon after transplantation, or was stifled under the growth of monetary nationalism which frequently found expression in a reaction against the 'anachronisms and anomalies' of the Bank of England way of central banking. The pre-War transformation of the Canadian and New Zealand central banks from private to public ownership immediately after their establishment illustrates this reaction. An echo of this reaction as well as of an abiding faith in Government direction was to be found in the bitter controversy that raged in India in the late 1920s over this question of 'state vs shareholders' type' of central banks, leading to the eventual withdrawal of the Reserve Bank of India Bill of 1927.

Another factor which has served to formalise the relationship between the central bank and the Government is to be found in the specific circumstances of the country in question. Central banks in some instances failed in the past to fall in line with the employment policies of the Governments. The Commonwealth Bank of Australia was unwilling to assist in the rehabilitation plans of the Government during the Great Depression. So, too, the Bank of England at about the same time had not approved of the growing expenditure of the Government on unemployment. The Australian Commonwealth Bank was subsequently nationalised so that it could better serve as an instrument of Government policy. The Bank of England could not be nationalised then for the Labour Government was defeated at the polls in the autumn of 1931, but immediately after returning to power the Labour Government did in 1946 what it could not do in 1931.

In the postwar years the policies of economic planning and full employment to which most Governments have been wedded have accentuated the trend towards the statutory definition of relations between the Government and central banks and has hastened the movement towards nationalisation of

[21] L. L. Minty in the *Journal of the Institute of Bankers*, London, July 1946, p. 145.

[22] *American Economic Review*, September 1948. Article by M. A. Kriz entitled "Central Banks and the State Today", pp. 371-73.

central banks. It is well known what an important role deficit spending has come to play as a method of achieving and maintaining full employment. One of the fundamental problems related to the creation of employment by this metod is the question of maintaining the rate of interest at a low and stable level. The rate of interest can be prevented from rising if a proper banking policy is followed. The essence of this policy is to expand the cash basis of the member banks so that they may expand their deposits sufficiently and maintain, at the same time, their legal or customary reserve ratio. When the Government is pursuing a policy of full employment by means of deficit financing it must be sure that the rate of interest is definitely under its control and cannot be raised against it. The central bank inevitably becomes a part of the Government machine[23] and this position of the central bank is formalised by its nationalisation. It will no longer be possible for a central bank to flout the powers of the Government or thwart its policy as the Bank of England or the Commonwealth Bank attempted to do in the past.

IV

Central Bank–Treasury Friction in India, Canada, Sweden and the USA

The trend towards Government control and Government ownership as reflected in post-War central banking developments should be carefully noted in the Indian scene also. There has been a widespread demand for a Government bank in India for a long time and it may be recalled that the first Reserve Bank Bill foundered on the question of independence from political control. At that time Government banking institutions in the world were very few in number and this was one of the strongest points in favour of the shareholders' type of central banks. But circumstances have since changed entirely. The number of Government banks has been steadily on the increase and during the post-War years the trend towards Government control and ownership has been unmistakable.

In some quarters, the view that the central bank should be independent of the Government has been expressed; but even the term 'independence' according to the authors of a classical work on central banks, means that in regard to important problems both the central bank and the Government should closely and continuously cooperate with each other and that there should be an even closer relationship during periods of grave emergencies such as war and economic crises.[24] In other words, the Government and the central bank should function as 'partners' and the central bank need neither be completely independent of the Government nor completely subordinate to it.

The concept of the 'independence of a central bank', however, implies certain essential features. There should be adequate representation of interests

[23] Basu, S. K., *Recent Banking Developments*, The Book Exchange, Calcutta, 1946, pp. 73-74.

[24] Kisch and Elkin, *Central Banks*, p. 18.

like those of commercial banking, industry, and trade on the Directorates of central banks. Further, the provision that the Government should give directions to the central bank only after consultations with the central bank should be adhered to and the Government should make it a point not to issue directions without consulting the central bank.

No doubt, there were differences of opinion between the Government and the Reserve Bank; but these differences existed before the country became independent. After Independence, there was no instance of any serious conflict or difference of opinion between them; on the other hand, perfect agreement was noticed on many important matters like cheap money policy and open market operations.[25]

The Reserve Bank, though it cooperated with the Government in carrying out its policies did not give up its independent attitude and often represented the interests of the nation whenever it felt that the policies of the Government were not conducive for the good of the people. It may be mentioned that a warning was given by it about the risks inherent in accumulating sterling balances and the British Government was advised to put an end to the export of important commodities. The Reserve Bank also made a suggestion in 1945 that the British Government should make its disbursements in either bullion or capital or consumer goods, or in foreign currencies. In 1946 it emphasised the risks which the Government of India would have to face by pursuing extensively its cheap money policy.[26] The budget proposals of Mr Liaquat Ali Khan were also strongly criticised by the Board of Directors of the Reserve Bank in 1947 which clearly pointed out how they would adversely affect the interests of the country. It was questioned whether the Reserve Bank of India would still have done so had it been Government owned. The fear that the Reserve Bank and the country would not have the advantages of the advice and the wise guidance of an able and independent Board of Directors in the event of nationalisation was also expressed; for a Government owned bank would only have directors nominated by the Government who might merely be 'yes' men who might not be bold enough to express their views. There was the possibility of the Reserve Bank becoming merely another department of the Government. On the other hand, an independent Board of Directors would examine the policies of the Government impartially and express their opinions without reservation or hesitation, pointing out defects, if any.

An assurance to the effect that the Reserve Bank of India would continue to function as an autonomous institution was expressed by the then Finance Minister R. K. Shanmukham Chetty. It was also observed that adequate representation of various interests would be made in the Board of Directors so that the institution could be made an object of democratic processes. Doubts were, however, expressed in some quarters as to how far the successive Governments would observe these valuable and healthy conventions laid down by the Finance Minister.

[25] *Commerce*, May 22, 1948, also speech by Mr M. C. Chidambaram, Chairman, the Indian Overseas Bank Ltd., at the Annual General Meeting of Shareholders, March 1948.

[26] Panandikar, S. G., *Banking in India*, Orient Longmans, Bombay, 1966, p. 380.

A brief study of the relationships between the central banks and the respective Governments of some countries is instructive and a few general principles to be observed by both authorities may be deduced.

The most recent case which focussed wide public attention on this subject is that of the Governor of the Bank of Canada during the period 1955–61. Mr James Coyne joined as the Governor of the Bank of Canada early in 1955, his term of office was for seven years. The Bank of Canada Act does not leave any supervisory or regulatory power in the hands of the Government. According to the Bank of Canada Act, the appointment of the Governor, the Deputy Governor and the other Directors is made by the Government after which they have a free hand to discharge their duties in the manner which they consider best.

Mr James Coyne held certain views in regard to the pressure faced by the Canadian economy on account of the influx of capital from the USA and the way in which the problem could be tackled. He expressed these views in speeches which touched not only upon subjects like the expansion of credit and currency and the external value of the dollar but certain other matters like fiscal and economic policies over which the Bank had no control. The Minister of Finance did not like the speeches of Mr Coyne but kept quiet for a while. However, Mr Coyne persisted in giving strong expression to his views. The Finance Minister and Mr Coyne had differences of opinion on other subjects also and matters soon came to a head. The Governor was asked to resign but he declined to do so. Some way had to be found to resolve the deadlock; finally, a bill was introduced in Parliament to empower it to dismiss the Governor. However, after an unhappy discussion in Parliament, Mr Coyne resigned of his own accord.

Although Mr Coyne's case has been the most publicised, there have been other cases equally dramatic in nature. In Sweden some years back, the bank rate was raised by the Riksbank from 4.5 per cent to 5 per cent. This was done without consulting the Government which did not like the action of the Riksbank. According to the constitution of the Riksbank, the Chairman (who is different from the Governor) is appointed by the Government while the Governor and the other Directors are elected and are answerable only to Parliament. The Prime Minister sent for the Governor of the Riksbank, objected to the action of the bank made without consultation with the Government and demanded that he should resign. But the Governor was adamant and declined to submit his resignation on the ground that his responsibility was not to the Government but only to Parliament. There was, thus, a tussle between the two authorities. At last, both of them reached an understanding according to which the bank agreed to consult the Government and take its advice before making changes in in the bank rate and thus the dispute was settled.

The third instance was in the USA where a conflict developed between President Truman and Mr Marriner S. Eccles, the Chairman of the Board of Governors of the Federal Reserve system, regarding the policy of open market operations. The Administration was particular about the maintenance of current prices of gilt-edged securities and, therefore, wanted the operations of the Federal

Reserve to be conducted in a way which would keep their prices at that level. But the Federal Reserve was of the view that the adoption of such a policy would mean putting more money into circulation which would worsen the inflationary conditions prevailing in the economy. When President Truman became aware of this difference of opinion, he sent for Mr Eccles and, in his discussions, emphasised the need for preserving "public confidence in Government's credit and in Government securities."[27] After these discussions, a notification was issued by the White House to the effect that the Open Market Committee had accepted the views of the Administration. When he saw this notification, Mr Eccles issued another notification denying it and soon afterwards tendered his resignation. Mr Eccles defended his views in a letter to the Douglas Committee dated December 1, 1949, pointing out that the conduct of open market operations so as to maintain prices of Government securities would aggravate inflation. The hearings before the Douglas Committee which was considering the whole question of the relations between the Treasury and the Federal Reserve do not give the impression of friendly cooperation and honest differences among friends. The conflict became rather pronounced and the balance of power shifted sometimes in favour of the Treasury or again in favour of the Federal Reserve.[28]

V

Constitutional Provisions Governing Coordination of Policy and Demarcation of Responsibility Between the Reserve Bank of India and the Government

A central bank cannot possibly act contrary to national economic policy. Subject to this limitation it may enjoy a considerable degree of autonomy within the field of monetary and credit policy determination. The statutes of central banks even in the case of nationalised ones, however, have not always found it necessary or feasible to make a clear-cut demarcation of responsibilities between them and the Government or to lay down constitutional or formal administrative arrangements governing coordination of policy between the two bodies. Thus, there is no constitutional provision indicating the line of demarcation between the Reserve Bank of India and the Government in the field of monetary authority. In practice, in respect of the operation of monetary instruments, the Reserve Bank generally takes action on its own initiative. But in the case of the bank rate there has always been previous consultation with the Government. The rates of stamp duty on usance bills are fixed by the Government; and by varying these rates the Government can nullify the effects of a change in the bank rate or alter the cost of borrowing from the Reserve Bank against this security even when the Reserve Bank has not moved the bank rate. The latter happened in 1956 when the Government enhanced by legislation the permissible rates of stamp duty on usance bills. The convention has since been established

[27] Iengar, H. V. R., op. cit., p. 283.

[28] Fforde, J. S., *The Federal Reserve System*, 1945-49, Oxford University Press, New York, pp. 321 and 338.

that changes in the rate of stamp duty will be made only after consultation with the Reserve Bank. In practice the Government's power to vary the stamp duty does not, therefore, impair the Reserve Bank's primary responsibility in regard to fixing the bank rate.[29]

The Governor of the Reserve Bank of India believes that if a distinction is drawn between monetary and fiscal problems and the responsibility for dealing with the two groups of problems is allocated between the Reserve Bank and the Government respectively, there will not be any room for conflict and controversy. The Reserve Bank of India's responsibility is direct and unquestioned with regard to credit policy, the operation of the monetary mechanism, and the maintenance of currency stability. The Government of India has been endowed with statutory power to issue directions and has the sole power to deal with questions relating to fiscal policy. It is true that monetary policy may be affected by fiscal policy especially in a developing economy like India's. In such circumstances it is the duty of the Reserve Bank to communicate its views to the Government on controversial fiscal problems confidentially. It should also inform the Government to what extent its responsibility to maintain monetary stability is being impaired by the Government's fiscal policy.

What exactly is the position of the central bank *vis-à-vis* the Treasury? Should the central bank be subservient to the Government or independent of it? Or should it cooperate with the Government in the execution of its policy even though it does not see eye to eye with it?

The central bank has certain important functions and responsibilities in modern times. It has to act as a watch-dog over the various developments in the country and is in a special position to take stock of the overall economic position in an objective manner. The Government is, no doubt, interested in promoting the economic prosperity of the people; and for this purpose, it harnesses the resources of the country to the maximum advantage. But it cannot, and may not, always take an objective view of the situation. The actions and policies of the Government are based on the policies of the party in power and, more often than not, it is the will of the leader of the majority party which prevails in the country. It is in this context that the responsibility of the central bank assumes special importance.

Further, the special significance of monetary policy has been recognised in recent times. In the 1930s, fiscal policies were considered to be far superior to monetary policies and hence monetary policy lost its importance to some extent. But, ever since the fifties, it has been recognised that monetary policy could play a useful role in achieving economic stability. This would clearly bring out the special role of the central bank in modern times. The problem involves not merely a mutual recognition of the respective role of each but also an adjustment of attitudes towards policy making.

[29] *The Radcliffe Report*, Vol. I, p. 255.

VI

The Question of the Independence of the Central Bank

In underdeveloped countries with immature banking systems and with the doctrine of state-directed economies having full play, the concept of a private shareholders' central bank was an anomaly. In the context of the highly complex economic and financial structures of most civilised countries nowadays and against the background of policies of full employment pursued by them, the old concept of a central bank confining itself to its own business in a state of isolation from the Government and politics has also become unworkable. A central bank cannot, obviously, pursue a policy that runs counter to the objectives of national economic policy. It has now become increasingly evident that monetary policy and general fiscal policy are part of the overall economic policy of the Government. The position today has been aptly expressed by one who is both an academic economist and a practical central banker that the central bank has to be regarded as an integral part of the Government but with a life and ethos of its own.[30] The central bank as essentially a public institution can hardly be independent of the Government. Thus, the concept has been developed that the central bank, though fairly independent, should act in the closest harmony with the Government. There should be a great deal of informal consultation and close working contact between the two. This view of the position of the central bank *vis-a-vis* the Government is taken even by the Governor of the South African Reserve Bank, which is still a shareholders' type of central bank, who observed before the Radcliffe Committee that his bank was satisfied to regard its independence as independence within the Government rather than of the Government.[31] Throughout the long history of central banking in the USA, this question of independence has been thoroughly debated and even there it has been maintained that the Federal Reserve System should be independent, not of the Government, but with the structure of the Government.

VII

Central Bank Independence Subject to the Supreme Authority of the Government: True Position of the Reserve Bank of India and the Government

The divergences between the viewpoints of the Governments and central banks are of a structural character, and they should be accepted in the interests of the institutions concerned. The fact that such differences exist is the best evidence that the institutions are functioning well.

[30] *Three Banks Review*, September 1963, Sayers, R. S's article entitled "Cooperation between Central Banks". Also article by Lord Cobbold, "Some thoughts on Central Banking", *Journal of the Institute of Bankers*, February 1963.

[31] *The Radcliffe Committee Evidences*, Vol. 1, pp. 256, 286 and 295.

Ministers of finance and those responsible for monetary policy are sometimes bound, by the very reasons of their differing responsibilities, to have divergent views on how to resolve big financial problems. The former, who have to take certain political factors into consideration, will tend to regard these problems in an immediate context without concerning themselves too much with the consequences of their decisions. The others, on the other hand, by reason of the permanent nature of their office and the technical background they must possess, will generally take a fuller account of the long-term implications of their decisions. It is the confrontation of these two viewpoints that will ultimately enable the best solution to be found. Some people may perhaps feel that, in the event of profound disagreements on the policy to be pursued, means should be provided of arbitrating on the divergent opinions, or that the Government should be afforded the possibility of imposing its views.

Where the central bank is more removed from political influences and more independent from Treasury problems, it can use its greater knowledge and technical experience of financial markets and of the implications of monetary policy to act more objectively in monetary matters. The Government should listen to the technical advice of the central bank, which should have the power to close the door in case of imminent danger of abuse of monetay policy. All in all, the ideal has prevailed that it is in the general interest for the central bank to pursue its independence from the Government.[32]

However, according to Dr Guido Carli, the Governor of the Bank of Italy, a central bank should argue dialectically, detachedly and point by point with the Government, with the centres of organised power and with pressure groups on new points of policy. If the Governor's views are contrary to those of the Minister, the Ministers have to take a decision—that is invite the Governor to resign. The Governor under the Italian law is armed with certain powers.[33] For instance he can decide the volume of rediscount. Here he acts according to his own judgment and if his judgment is found contrary to the Government's views, he will have to resign. According to Dr Carli, the strength of the Governor lies in having no external support except his own conscience.

Does this mean that the central bank should be completely independent of the Government? If this were to be the case, the central bank would be an authority having almost equal powers with the Government with the result that they may pull in opposite directions causing frequent conflicts which are not desirable from the point of view of the administration of the country. On the other hand if the central bank is completely dependent on the Government, it may not discharge its functions properly and effectively.

According to the Bank of England, the central bank must have supreme authority in the discharge of its 'own functions'. This view was, however, not accepted by the Radcliffe Committee which thought that monetary policy should not be looked upon as a kind of 'economic strategy' pursuing its own independent aims and that economic policy, whatever shape it might assume from time to

[32] The *Per Jacobsson Foundation Lecture*, November 9, 1966, Commentary by Dr Kranza Aschinger.
[33] Article 25 of the Statute of the Bank of Italy.

time, certainly includes the broad objectives and outlines of monetary policy and monetary operations. Further, the Committee expressed clearly that, from the beginning to the end, the policies followed by the central bank should be in conformity with those upheld by ministers who are responsible to Parliament. Thus, the Radcliffe Committee expressed its dissent from the views of the Bank of England in unambiguous language.[34]

In India, also, the position of the central bank *vis-à-vis* the Government has been defined in a statement by a former Union Finance Minister:[35]

> The Governor of the Reserve Bank...is entitled to criticise the Government, to differ from Government....We can...issue directives: but the Reserve Bank can hold a different opinion...and also publish it in his report that the Government of India was advised in the matter....

This sets out very fairly the relative responsibilities of the Reserve Bank and the Government at present and it is hoped that it will continue to be regarded as the charter for the vital role that the Reserve Bank has to play in shaping the economic destiny of the nation.

The Reserve Bank is managed by the Governor who is the chief executive and whose position is unique. The Governor has to take the initiative in the matter of controlling credit and help in maintaining stability in the value of the currency. In some cases, the Government may accept the advice of the central bank and there may not be any difficulty. If, however, there are differences of opinion between the central bank and the Government on matters such as stability in the value of the currency and control of credit, subjects in which the central bank has a special and important responsibility, some difficulties may arise. In these cases, the views of the Governor of the Reserve Bank, those of the Government and the reasons for the nonacceptance of the views of the Governor of the central bank should be publicised. All these could be discussed by the public or Parliament or by a Parliamentary Subcommittee.[36] Such a step would definitely give prestige and importance to the central bank and its views; it would also mean that another impartial body or bodies would be able to view, in proper perspective, the reasons why the Government did not act in accordance with the advice or recommendations of an expert authority like the central bank.

The question arises here as to whether it may not be advisable to fix a limit to the quantum of loans taken by the Government from the central bank. In the USA, there is such a ceiling. This amount may be stipulated as a certain percentage of the national income. During periods of depression, when it becomes necessary for the Government to borrow more funds from the central bank, this ceiling may be raised suitably.

The functions and responsibilities of the Bank of England and the Government in the fields of money and its management are different and separate; but, quite frequently, they overlap. The Bank is charged with the direct responsibility

[34] *The Radcliffe Report*, p. 273.

[35] Speech by Mr. T. T. Krishnamachari, Finance Minister, in the Rajya Sabha on December 21, 1957.

[36] Sir William Meyer Endowment Lectures delivered at the University of Madras in March 1965 by Mr H. V. R. Iengar, former Governor of the Reserve Bank of India.

of managing the money market, which includes subjects like the bank rate, open market operations and the credit base. The Treasury is responsible for budgetary and fiscal operations and also other matters such as Exchange Equalisation Account and schemes of Government borrowing which have their reactions and effects on the money market also. In regard to the two last subjects mentioned, the Government is, perhaps, the ultimate authority to decide —the Bank is merely the agent which gives advice and carries out the operations.[37] Apart from this, the Government has overall supremacy to ensure that monetary policy is in harmony with the economic policy of the country. The Radcliffe Committee had this to say on the subject:

> The Central Bank is one of the principal authorities concerned with the framing and operation of monetary policy...the policies to be pursued by the Central Bank must be from first to last in harmony with those avowed and defended by Ministers of the Crown responsible to Parliament...

In general, it may be observed that there is something like a banker-customer relationship between the central bank and the Treasury. Of course, some honest differences of opinion may arise between the two authorities; but this should not stand in the way of cooperation between them. It is also possible for the Chancellor of the Exchequer to overrule the Governor of the Bank, which also happens occasionally. But the Governor of the Bank still enjoys respect and there is mutual esteem and understanding between him and the Finance Minister. The relationship between the Bank and the Government has been quite smooth and cordial and no written directions have, so far, been given to the Bank.[38]

In the USA, the Federal Reserve Board of the Federal Reserve System is, in general, empowered to take decisions as regards monetary policy. This Board consists of seven members who are appointed by the President after getting the consent of the Senate and their terms of office is fourteen years. The Congress has no power to give directions to the Board, and in this sense, the Board enjoys independence from the Congress. Still it is difficult to locate where exactly the final authority regarding monetary policy lies in the USA, if not in the Federal Reserve Board. A Committee of the Congress, the Patman Committee, came to the conclusion that the independence of the Federal Reserve System is desirable, not because it is an end by itself but because it is a means through which the "best overall economic policy" can be formulated and that this independence "must be an independence within and not from Government". This view has great force as it is necessary for monetary policy to be in conformity with the general economic policies of the Government.

There are certain requirements which have to be satisfied if both the Government and the central bank are to function in close harmony. The Government should have complete confidence in the central bank and the Governor, and the central bank should also recognise the fact that in financial matters, the Government is responsible to the public.

[37] Speech by Mr C. F. Cobbold, former Governor of the Bank of England at a dinner of the Ipswich Centre of the Institute of Bankers (published in the *Journal of the Institute of Bankers*, 1957, pp. 309-311).

[38] Iengar, H. V. R., op. cit., p. 286.

This does not mean that the central bank should always concur with the proposals of the Government. Mr Montagu Norman once observed: "I look upon the Bank as having the unique right to offer advice and to press such advice even to the point of nagging; but always, of course, subject to the supreme authority of Government." This view appears to be quite correct. On the Board of Directors, there should be persons noted for their independence who would be in a position to express their opinions without fear or favour. Thus, a cordial relationship between the central bank and the Government does not preclude the Governor or the Directors from expressing their views freely or frankly. Of course, the final authority should be with the Government, but the Treasury should make it a point not to interfere with the working of the central bank so long as the latter is following policies which are in consonance with the economic policies of the Government.

VIII

The Central Bank's Relationship with Politics— The American Experience[39]

Economists are in general agreement on three points: (i) the central bank should be independent of political influences—almost metapolitical; (2) it should remain subordinate in its powers to the automatic functioning of the gold standard; and (3) high quality commercial paper should be the only basis for central bank credit extension. John R. Commons[40] observed that the inflationary policies of the Federal Reserve Board during 1919–21 were caused by the dominant place on the Board held by the Secretary of the Treasury who was compelled to float

> Government securities at less than the current rates of interest.... The Secretary's ambition to make a successful record in the patriotic policy of floating enormous loans at low rates of interest prevented the board and banks from doing...what should have been done.

Harold Reed who was especially critical of the strategic imponderability of the Board of Governors wrote,[41]

> ...whenever wide differences of opinion exist it is inevitable that slow and tedious diplomacy must be exercised before substantial unanimity of thought can be gained and aggressive action taken. Continuous concessions of judgement must be made in a field in which history records few successful compromises.

39 This section is primarily based upon Professor Richard H. Timberlake's paper on "Politics, Economists, and the Central Bank" published in the *Western Economic Journal*, Vol. IV, No. 3, Summer, 1966, pp. 281-296.

40 Commons, John R., "Stabilization of Prices and Business", *American Economic Review* (*AER*), March 1925, p. 46.

41 Reed, Harold T., "Recent Work of the Federal Reserve Administration", *AER*, March 1926 (Proceedings), pp. 303-04. Reed quoted an editorial of the *Commercial and Financial Chronicle* to much the same effect in which the author (a Mr Dawes) stated that this imponderability would exist even if "the ablest men in the world would always sit on the Board", p. 304.

B. H. Beckhart agreed with Reed's condemnation of the encroachments of the politicians on Federal Reserve credit policies.[42] He added:

> It is deplorable that political influences have played such a prominent part in the Reserve System not only as regards appointments to the Board, but even as regards the fixing of the rates of discount.

What neither Reed nor Beckhart was willing to recognise or to admit was that politicians must have had a vested interest in the results of monetary policy. Hand-slapping by economists and suggestions couched in terms of what the system ought to be like were useless if the Federal Reserve System could not be politically independent and incontestably scientific.

The right of the President to appoint the Governor and Vice-Governor of the Federal Reserve Board was "cause for alarm on the part of the large body of students (economists?) and bankers who realised the vital necessity of independence from political influence in the management of any central banking system".[43] He lamented repeatedly: "The Federal Reserve Board although ostensibly independent, has...come practically under political domination."[44]

Jacob Viner commented that any changes in the Federal Reserve Boards' operations would be "because of changes in the personnel with whom the power of control rests". Stressing that the board should not be the pawn of the Executive, he argues that

> Harmonization of the two sets of authorities (fiscal and monetary) must be through exchange of views between agencies which meet as equals rather than by making one agency the mere instrumentality of the other.[45]

In effect, the two sets of authorities did not meet as equals, and Viner gave no particulars as to how 'harmonziation' might be accomplished.

The Hoover Commission's investigation in 1949–50 included a study on the role and placement of the central bank in the structure of Government. The Commission's chief economist for this study was G. L. Bach. In spite of the legal divorce of the Federal Reserve Board from the Treasury in 1935, "credit policy since 1935 has been more rather than less consonant with Treasury financing needs".[46] In the informal negotiations on monetary and fiscal policy between officials of the two agencies "personalities of the various top officials...have influenced substantially the nature of the negotiations and the relative strength exerted by the two agencies".[47] Treasury leadership develops, he emphasised, because of the System's 'independence'. That is, a single-minded Treasury having close ties with the President and his executive officials "is invariably the stronger bargainer."[48] He suggested that monetary policy be brought under a National Monetary Council consisting of the Secretary of the Treasury, the

[42] Beckhart, B. H., "Federal Reserve Policies—Discussion", *AER*, March 1926, p. 325.

[43] Bradford, Frederick A., "The Banking Act of 1935", *AER*, December 1935, p. 667.

[44] Ibid., pp. 671–72.

[45] Viner, Jacob, "Recent Legislation and the Banking Situation", *AER*, March 1936 (Proceedings), pp. 113-114.

[46] Bach, G. L., "The Federal Reserve and Monetary Policy Formation", *AER*, December 1949, p. 1181.

[47] Ibid., p. 1179.

[48] Ibid., p. 1181.

Chairman of the Board of Governors, the Director of the Bureau of the Budget, and others.[49]

P. B. Whale, a British economist, writing in 1939 on the impossibility of central bank independence stated that "The real difficulty at present. . . is that economists are not in a position to assume the role of experts (on monetary policies), because of their failure to agree amongst themselves."[50]

A political scientist, Michael Reagan, recently compared the political structure of the Federal Reserve System with other contemporary policy-making agencies. He agreed with Bach and many other economists that "Insulation of politics (by the Federal Reserve Board) is as impossible as it is democratically undesirable for an agency functioning so near the center of national economic policy".[51]

The core of the dispute in the USA lay in the allocation of authority with regard to monetary and debt management policies. There are three means possible to prevent unseemly conflicts between the central bank and the Government in the future.[52] One is to give either agency full executive responsibility for combined monetary-fiscal policy. A second possibility for reforms is to put the executive heads of both agencies on an equal footing. The third method suggested is to proscribe any discretionary policy for either agency and put the essential operations of policy under a system of rules. The Douglas Committee, however, was not in favour of concentration of monetary-debt management policies either in the Treasury, or in a newly created Department of Money and Finance or in the Federal Reserve itself. Three general methods have been suggested by the Douglas Committee for securing more appropriate debt management policies. Firstly, the building up of the quality and prestige of Federal Reserve officials. Secondly, the issuance by the Congress of general instructions to both the Treasury and the Federal Reserve regarding the division of authority over monetary and debt management policies and the objectives of these policies. Thirdly, the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System should be made members of the National Monetary and Credit Council proposed by the Committee.[53]

It would serve society badly if monetary policy is not kept above party politics, it may lead to the neglect of the human ingredients on which exercise of discretion depends. "To forget this is to overlook that which makes economists most useful to central banking. And it is to forgo that which makes central banking most interesting to economists.[54]

[49] Ibid., p. 1185.

[50] Whale, P. B., "Central Banks and the State", Manchester School, January 1939, p. 49.

[51] Reagan, Michael, "The Political Structure of the Federal System," *American Political Science Review*, March 1961, p. 68.

[52] This has been suggested by Michael Reagan in *American Political Science Review*, March 1961, pp. 64-76. Also Timberlake (Jr.) *Money, Banking and Central Banking*, Harper & Row, New York, 1965, p. 344.

[53] Basu, S. K., *A Survey of Contemporary Banking Trends*, The Book Exchange, Calcutta, 1965, pp. 53-61.

[54] Whittlesey & Wilson, Ed., *Essays in Money and Banking in honour of R. S. Sayers*, Clarendon Press, Oxford, 1968, pp. 264-265.

IX

Observations

The idea of the independence of a central bank has been overborne in recent years by newly evolving conceptions of the role of the Government in the development of a country's economy and the place of monetary policy in the totality of the overall economic policy. During the gold standard era 1870-1914, one could have spoken of the independence of a central bank because its operations were, by and large, automatic and because the shaping of monetary policy so as to maintain full employment or promote economic welfare was not considered part of the central bank's responsibility. But with the abandonment of the gold standard in the 1930s, a reappraisal of the division of functions in the field of monetary policy between the central bank and political authorities became necessary.

The traditional 'conservatism' of central bankers responsible for the painful deflationary policies witnessed in the 1930s has undoubtedly waned under the influence of Keynesian economics. There is hardly any central banker today who will be insensitive to the danger of mass unemployment. The revival of overdeflationary central bank thinking so familiar in the heyday of the gold standard is unlikely in the present conditions. But, at the same time, there is general unwillingness to concede that the central banking agency should be so independent of the Government that it will be able to regain its operating policies. In the circumstances there is a body of responsible opinion which favours an equal hearing for the Government and central banking viewpoints in the determination of the Government policy and then unified action on that policy which the Government judges best. In the event of a failure of a Government-central bank compromise, a reference of issue to a National Monetary Council or even to the President is sometimes envisaged.

Important structural and institutional changes have taken place in the planned economy of India. The Government of India has had to assume larger responsibility for much more ambitious objectives of economic policy than ever before. The maintenance of full employment and the achievement of a rapid rate of economic growth have become important responsibilities of the Reserve Bank of India since the commencement of the planning era. Monetary policy of the central bank cannot be envisaged as a form of economic strategy having no relation to the objectives of the Government's overall economic policy. A new set of tools, entirely different from the simple instrument provided by the bank rate under the gold standard, is now required for the fulfilment of these objectives. These and other related developments brought about profound changes in the traditional division of functions between the political authorities and the Reserve Bank of India. For instance, while the Government was pursuing a policy of deficit financing, the central bank in such circumstances inevitably became a part of the Government machine. The enormous growth of public debt in the period after World War II has also been an important specific fact which contributed to the shift in the relations of the Reserve Bank of India and

the Government in the present times. The exigencies of debt management have endowed the Government with an unprecedented responsibility for monetary policy and a dominance over the central bank that could not be foreseen. Thus the philosophy of the relationship between the central bank and the Government is entirely different today in the new economic circumstances. The old concept that the central bank should not pay too much regard to politics and political authorities and that it should get on with its own business has been replaced by the new concept that the central bank, though fairly independent in its thinking and operations, should act in close harmony with the Government.

The subject, as already observed, acquires greater significance in the context of planning for development. There has, so far, been one resignation by a Governor of the Reserve Bank of India. The suggestion that provision must be made for the publication of the advice of the Governor of the Reserve Bank in cases where the Government does not act in accordance with the advice of the Reserve Bank on matters like monetary policy and the value of the currency makes one feel that some honest differences of opinion might have prevailed between the Reserve Bank and the Government of India. The cordial relationship that has, generally speaking, so far existed between the two authorities is not automatic but is due to the conscious adjustment made by both parties[55] on account of the fact that the Government may desire to introduce social changes as quickly as possible while the Bank may like to be cautious in its policies, thus giving rise to a conflict between them.

The whole structure of the Reserve Bank administrative machinery is archaic. So far, the practice in India has been that of appointing Members of the Indian Civil Service (ICS) to the post of the Governor of the Bank. These officials are generally close associates of the Ministers. It is quite likely that they may have received favours from the Ministers; and it is not unlikely that, even after retirement, they may think of taking the help of these Ministers. Thus, there may be rich rewards for kowtowing to the political authorities in power. So, the question arises as to whether the Governors of the Bank would boldly put forth their views and as to whether, even if they have the courage, they would speak against the wishes of the Government.

Further, the practice of appointing members of the ICS to the exalted office of the Governor may, generally speaking, raise the issue as to whether all ICS officers would be able to manage the affairs of the Reserve Bank efficiently and properly. The hegemony of this heaven-born class in the topmost executive position in the Reserve Bank administration is complete and almost unshakable. It is no doubt true that the ICS cadre consists of very eminent and talented persons: but the question also arises as to whether ICS officers have the ability to successfully administer the banking system and as to whether their lack of adequate knowledge of banking affairs may not act as a handicap.

A number of industrialists and businessmen have been nominated as the directors of the Reserve Bank. This further raises the question as to whether

[55] Speech by Mr H. V. R. Iengar on January 23, 1962, in Bombay on "Relationship between the Government and the Reserve Bank".

these directors would freely express their views without fear or favour as they may expect concessions from the Government in the form of permits, licences and quotas. In India the Government has greater control over economic matters than in other countries in view of planning for development. Hence it may not be possible for such members of the Board who are drawn from industry and commerce to freely express their views even though they may be actuated by the highest sense of duty.

Of late a number of professionals have been nominated to the Board of Directors of the Bank; professionals who need not depend on Government favours, who will be able to give expression to their views freely. This is a healthy trend. It should, however, be recognised that the maintenance of the independence of the Board cannot be assumed to arise automatically from its structure; it must continue to be consciously nurtured and welcomed.

There are four subjects over which there may be disagreement between the Reserve Bank of India and the Government. They are the interest rate policy, the volume of accommodation to be given to the Government (deficit financing), the manner of handling substandard banks, and policy in regard to accommodation to cooperative institutions.[56]

The rate of interest is the price to be paid for obtaining capital. Since the demand for capital is great in a developing economy savings can be attracted for investment only through an increase in the rates of interest. But the Government, which borrows money for developmental purposes, may like to maintain low rates of interest so that they can borrow cheaply. The pursuit of a cheap money policy may, however, lead to a fall in savings. Therefore, a conflict may arise between the Reserve Bank of India which may favour a rise in the rates of interest and the Government which would favour a low rate of interest.

The Reserve Bank should always be careful and alert and keep a close watch over the situation in the economy caused by deficit financing; whenever it feels that deficit financing is undertaken excessively, it should not hesitate to bring the matter to the notice of the Government and offer its advice. Thus, there may, on occasions, be some difference of opinion between the Reserve Bank advocating caution in deficit financing and the Government which may resort to excessive deficit financing to meet its requirements.

The question of amalgamations of banks has assumed great significance during recent years. The most important objective in undertaking amalgamations is to strengthen the banking structure and consolidate the banking system (see Chapter 12). Here again, a conflict may arise between the Government and the Reserve Bank. The Government may be subjected to pressures from a number of quarters, including political circles, and they would also have to consider the desires and the preferences of the local public. But the Reserve Bank would attach importance only to two criteria: the efficiency of working and the ease and speed with which amalgamations can be carried through. The Government may feel that the attitude of the Reserve Bank towards the cooperative movements is too conservative and that it can afford to take greater risks, while the

[56] Iengar, H. V. R., op. cit., pp. 290-295.

Reserve Bank may desire to follow a cautious policy in the development of cooperatives. It may, however, be observed that the differences are likely to be more frequent on the raising of interest rate and deficit financing than in the matter of financing cooperatives or promoting amalgamations.

Recent appointees to the Board of the Reserve Bank of India have been selected primarily on political grounds, rather than on the basis of banking experience. The record of achievement of the Central Board in regard to policy is not such as to inspire confidence in their judgement. Some observers believe that the structure of the Bank is dangerously anachronistic because it does not allow democratic processes to operate in the area of monetary policy. Just as in other fields of policy that embrace sharp cleavages of opinion,the democratic process must include three political procedures. The majority opinion must have the facility for getting its will into action. Minority opinions must have the right of criticism and challenge, and the right of succession to decision-making power if their challenges cannot be denied by the erstwhile majority.[57]

As matters stand now the Reserve Bank is subject to none of this machinery in its policy operations. It was meant *not* to be so subject. It is always influenced by the strongest political consideration rather than purely economic views. A substantial measure of Government participation in the appointment of the Governor, Deputy Governors and Directors is to be observed in the central banking statute of India. The most important provision of the Reserve Bank (Transfer to Public Ownership) Act, 1948, relates to management. The relevant clause follows closely the corresponding clause (4(1) and (2)) of the Bank of England Act, 1946. Under the clause the Central Government may, from time to time, give such directions to the Reserve Bank as it considers necessary in the public interest after consultation with the Governor of the Bank. Subject to any such directions, the general superintendence and direction of the affairs and business of the Bank has been vested in a Central Board of Directors. This Central Board consists of the following directors:

(a) a Governor and four Deputy Governors to be appointed by the Central Government (Section 8(1)(a) of the Reserve Bank of India Act, 1934),
(b) four Directors to be nominated by the Central Government, one from each of the four Local Boards as constituted by Section 8(1)(b),
(c) ten Directors to be nominated by the Central Government (Section 8(1)(c)), and
(d) one Government official to be nominated by the Central Government (Section 8(1)(d) of Act).

The provision for the last named Director is a remarkable contrast to the Bank of England Act, 1946, where under Section 4, Schedule I a person will be disqualified as a director if he serves a Government department. The Governor and a Deputy Governor shall hold office for such term, not exceeding five years, as the Central Government may fix when appointing them, and shall be eligible for reappointment. A Director nominated under clauses (b) and (c) of

[57] cf. Timberlake, Jr.'s paper on "Politics, Economists and the Central Bank", *WEJ*, Vol. IV, No. 3, Summer, 1966, pp. 281-296.

subsection (1) shall hold office for a period of four years. A Director nominated under clause (d) of subsection (1) shall hold office during the pleasure of the Central Government.

The short-term appointment of the Governor of the Reserve Bank in May 1975 aroused a lot of criticism. In order to ensure efficiency in the Bank's functioning some broad principles must be kept in mind in making the top appointments. The Government must cast its net far and wide in recruiting people to the top position and at the same time there must also be reasonable opportunity for the staff of the Bank to rise to the highest and second highest positions in it. Past experience indicates that adequate attention has not been paid in selecting persons to occupy the exalted position of the Governor. Generally speaking, the appointment seems to be of an *ad hoc* character. There should not be any rigid stipulation regarding the Governor's academic background though knowledge of banking and finance will be a great asset. Likewise, it is not necessary to select only Government officials for the Governorship. The appointee must have administrative experience, but this need not be in the Central or State Government only; it could be elsewhere too. While direct appointments would naturally have to be made to the Governorship, now and then a Deputy Governor should be promoted, not on the basis of seniority based on the date of becoming a Deputy Governor, but capability. Young and competent Deputy Governors should then be available from time to time to fill the post of the Governor. In the Bank's forty-year history only two Deputy Governors have become Governors.[58] Similarly in the case of Deputy Governors, the Government should follow a conscious policy of looking far afield. In the case of the appointment of the Governor there may be a certain hesitation on the part of the Government to select outsiders but there should be no hesitation in the matter of the appointment of Deputy Governors. The country has tremendous talent and it is the responsibility of the Government to locate it and use it fully. The country needs competent but relatively young Governors and Deputy Governors who have some incentive to show good performance in the Bank rather than coming there as tired or retired people.[59]

Nothing is gained by the traditional view that the 'right' answers to policy questions are purely 'scientific' and free of normative opinion. If anything, the diversity of opinions on monetary policy amongst economists becomes greater as times passes.[60] The economists and politicians are guided by so many conflicting considerations that they can hardly agree on any definite policy decision; instances abound when central banks have sadly endeavoured to dissuade inexperienced politicans from dangerous policies.[61] As already stated, the former

[58] The first appointment was that of Sir James Taylor, the second Governor of the Bank and next appointment was that of his successor, Mr C. D. Deshmukh.

[59] Sinha, S. L. N., Management of the Reserve Bank of India, Institute for Financial Management and Research, Madras, 1975.

[60] See for example, the answers economists gave to the Economic Policy Questionnaire in '*Tabulation of Replies Submitted to the Sub-Committee on Economic Stabilization*', 85th Congress, 2nd Session (Washington, D.C., 1959).

[61] Plumptre, A. F. W., op. cit., p. vii.

generally take fuller account of the longer-term implications of their decisions while the others tend to regard the problems in a short-term context. The cruel dilemma in India's planned economy is that political pressures lead to the undertaking of Plan tasks which look innocuous and even highly justifiable but which, with the available levels of administrative competence, are incapable of implementation.[62] In policy manoeuvres of any kind economists are at a disadvantage among lawyer-politicans. Jacob Viner[63] stated truly that "Politicians are experts in tracing one kind of repercussion, the political. But they are indisposed to take account of economic repercussions." The economist, on the other hand, is handicapped by inadequate knowledge of legal niceties and of actions that are administratively feasible.

The weakness of the present central banking structure is obvious. The Reserve Bank of India is independent by law but in fact subsidiary to the Government. Howard R. Bowen[64] suggested some years ago that the economist should "enlarge the scope of his studies to include systematic analysis of political consideration". Most economists probably have had no more than just a smattering of political science or jurisprudence. However, in applying political principles to monetary policy, many seem to have envisaged a sanctified place for the instrument of that policy, as though monetary policy were above the political smut that is a part of other policy spheres. As Anthony Downs remarked: "Economists have been content to discuss Government action as though Governments were run by perfect altruists whose only motive was to maximize social welfare".[65] Downs' criticism has been specially apparent in discussions of monetary policy, probably because the original central banking institution was organised on a limited and subordinate basis. Its evolution to a larger order of policy-making potential has been obfuscated, subsequently, by the first precept of abstinence from politics. Yet economists have not suffered by comparison with political scientists in analysing the political economy of central banking. A few economists who have dealt with this problem recognised its manifestations at an early date and treated it with rigour and thoroughness. Their principal shortcoming has been their inability to persuade most of their colleagues that a responsive and responsible policy-making institution in an area of intense controversy can no longer be independent of politics.

The conclusion is, therefore, that the day of the politically independent central bank supreme over monetary policy has passed.[66] As in the USA, it is unfortunate that the financial authorities and thinkers in India also had been governed by faddism and special political interest, while economists

[62] Deshmukh, C. D., loc. cit., p. 9.

[63] American Economic Review, January 1940, p. 5.

[64] Bowen, Howard R., "United States Monetary Policy—Discussion", *AER*, May 1952 (Proceedings), p. 264.

[65] Downs, Anthony, "An Economic Theory of Political Action in a Democracy," *JPE*, February 1957, p. 150.

[66] cf. Simmons, E. C., "Treasury Deposits and Excess Reserves", *Journal of Political Economy*, June 1940, p. 339.

had been lax in pursuing improvements in the system.[67]

The Reserve Bank of India continues to be India's central bank in the sense that it uses the tools of bank rate variation and open market operation along with other techniques of monetary control. These instruments have not only been hampered in operations by Government intervention and activities but the balance of power in monetary authority seems to have been removed from the Reserve Bank of India to the Finance Ministry. The Policy Board in the Bank appears to be owned and dominated by the Government. Government preponderance is also seen in the fields of money, credit, and bank supervision.

The entire inquiry into the Reserve Bank's relationship with the Government presents indications that the principles of democratic India demand a greater degree of autonomy for the Reserve Bank. The wide impact of growing debt on the Indian economy in the planning era not only suggests the desirability of harmonious cooperation with the Government but also presents a case for the utilisation of debt management as a stabilising device. All these have to be secured through some institutional arrangement and proper coordination of policies between the Government and a really autonomous Reserve Bank.

[67] H. Parker Willis bewailed the course central banking had followed since the inception of the Federal Reserve System. See his penetrating analysis "The Banking Act of 1933—An Appraisal", *American Economic Review*, March 1934 (Proceedings) p. 101.

15

Concluding Observations

Our investigation shows that all the world over central bankers have been playing a very crucial role in stimulating the growth of the national economy. A central banker's role, particularly in the less developed countries, is to foster the growth of banks and other developmental financial institutions and facilitate their work through maintaining conditions in the economy conducive to investment. Indeed, in the underdeveloped countries which are chronically short of capital, a great deal of the effort of the central banker may be devoted to improving the structure of financial institutions and financial markets so that the maximum amount of domestic savings may be mobilised and channelised for economically constructive purposes, thereby reducing the pressures for inflationary financing of development.

The goals of a country's economic policy provide the context for the functioning of a central bank. A central bank, thus, is not wholly free to pursue an independent course. The central banker's role is not that of a free agent. His task is to adjust to the broad aims of economic policy as adopted by his country. On the other hand, no arm of the Government is free to determine objectives and pursue them in defiance of the ultimate necessities imposed by monetary discipline. The precise nature of a central bank's relationship with the banking system depends on the matrix of economic and environmental conditions in which it has to work, and the type of responsibilities with which it is endowed. There is neither a 'standard pattern' nor a universal technique of central banking; each case—in whichever country or period—is a special problem. There is no single 'code of eternal rules' to be followed.

The economic system is a part of the social system and all aspects of change and growth are but a part of a global social process. The role of the Reserve Bank can, at no point of time, be viewed in static terms. The personality of the Reserve Bank is expected to assume new dimensions in the changing socio-economic climate which throws up fresh challenges necessitating new policies to promote the basic objectives of planning for economic development. No standardised form of central banking practices can be evolved, but diversifications and sophistications will evolve and emerge according to the individual needs of the economy.

Although the exact wording between the statute of one central bank and another may differ, the maintenance of monetary stability through regulation of the country's currency and credit system, is the basic responsibility with which all the central banks are charged. The central banks both old and young, in developed and underdeveloped economies, in independent and newly 'emergent' territories, are now regarded primarily as potential development agencies. In some statutes the broad objectives of economic policy, suh as sound economic development or maintenance of full employment, are specifically incorporated. "The promotion of the full development of the productive resources of Ceylon", "promoting a rising level of production, employment and real income in the Philippines", "fuller utilisation of the resources of Pakistan"—these are, among others, important objectives of the respective central banks as embodied in their statutes. Even where this has not been done a central banker today has to keep such objectives consciously before him all the time. This widening of the scope of responsibility of a central banker, whether explicit or implicit, has made his task much more difficult than in the past. The maintenance of monetary stability is, now, not an objective to be pursued for its own sake but only for the contribution that it can make to attain the overall objectives. There is, however, a certain degree of incompatibility between monetary stability and these overall objectives. Too much of the former stifles the progress towards the latter; while too rapid a pursuit of the latter endangers the former and becomes in the process self-defeating as it then hinders the progress in attaining these wider objectives. A central bank has, therefore, to strike a balance between the two and evolve a policy that ensures maximum progress in an atmosphere of stability. In addition, quite a large number of central banks have the responsibility of developing appropriate types of credit mechanisms to cater to the needs of certain vital sectors of the economy while administering banking legislation with a view to protecting the interests of depositors and regulating exchange control. In the absence of a central bank, a country's monetary system suffers from certain rigidities. The central banker must not remain content to cling steadfastly to traditional techniques. On the contrary, to use an expression of Professor Sayers, he must be quick enough to adjust his methods to the "shape of the constantly changing financial habits".

On the one hand, the central bank is the ultimate source of liquidity in a country, and on the other, it possesses a number of devices to control and direct the flow of funds to the desired channels. Apart from the discharge of its basic functions, the central bank acts as adviser to the Government on monetary and banking matters and maintains liaison between the Government and the banking and financial institutions in order to explain the problems of each to the other in working out appropriate solutions to them, and through such action facilitates attainment of its basic objective—stimulation of the growth of the economy. A central banker has to spell out the reasons behind the monetary policy actually pursued and to explain the implications of the measures taken. Here his pedagogic task is of great importance. There is a need for meaningful discussions of current business trends at home and abroad

and of the functioning of the money and capital markets as well as their improvement.

The Government of India, like that of many other developing nations, has been, and continues to be, anxious to embark on accelerated development plans in order to reach the stage of 'drive to maturity' within the shortest possible time. A central bank necessarily functions within the freedom and limitations set by the current economic philosophy of the country. If the dominant problem in a country is one of planned development, as in India, and the efforts of the whole country are directed towards the national resources so as to optimise the rate of development, there arises a new measure of judgment in the objectives of the central banker—the necessity for augmenting credit facilities and giving a purposive direction to credit. The development of this new angle is likely to lead the central bank to reformulate the monetary policy in a way which would encourage the flow of credit into desired directions without necessarily bringing about a contraction of the total quantum of credit. The central banking policy has, therefore, firstly to adjust itself to the framework of development plans. Once the size of the Five Year Plan is determined the Government has to resort to the well-known method of deficit financing through the creation of central bank credit because of the limited resources. This method of financing is inflationary in character. Consequently, to keep inflation within 'safe limits' the Reserve Bank has been called upon to play the role of a 'controller of inflation'. Thus, with slight modifications, Senator Douglas's analogy has become applicable to the case of the Reserve Bank of India. The task of trying to check inflation, while extending credit, will be as futile as trying to mop up the overflow from a bucket under a running tap with a pocket handkerchief. The Reserve Bank of India has thus necessarily to function within the conditions created in the effort to execute the Plans. The above factors, as we have seen, characterise the role of the Reserve Bank in the economic development of India.

The primary responsibility of the monetary authorities of a developing country, as in India, is to reduce the pressure of monetary demand without hampering production, so as to help maintain the predetermined pace of development. It follows that an attempt to provide adequate finance for encouraging production on the one hand, and to control the inflation generated through deficit financing on the other, makes the task of the central bank all the more difficult. Nevertheless, the nature of the problem of the development of India, at least in the initial stages, is such that aiming at one of the above objectives at the cost of the other would only be self-defeating. Consequently, the monetary policy has necessarily to assume this dual responsibility.

This concept of dual responsibility is essential to the understanding of the role of the Reserve Bank. When India launched her First Five Year Plan, the Reserve Bank began to operate on a new concept of its promotional and developmental role which implied the promotion and development of monetary, banking and financial institutions in a planned economy. This conception of a promotional role was very different from the accepted functions of central banking. Besides, this role was frequently in conflict with its traditional regulatory role of controlling the inflation that was generated in the economy as a

result of deficit financing. However, the Reserve Bank's promotional role was so essential in the case of India that it had to be pursued with enthusiasm. Simultaneously, with the acceptance by the Government of India of the concept of developmental planning, the monetary authorities were obliged to keep inflationary pressures under effective control. Ostensibly, therefore, the success of the monetary measures depended not only upon the ingenuity with which the policy was formulated but also upon the development of financial institutions within the framework of which the authorities had to function. It is, therefore, appropriate to conclude that from the inception of the First Five Year Plan it became essential for the Reserve Bank of India to deviate from the norm; along with the normal central banking functions of credit regulation, the Bank devoted an equal amount of energy towards the development of credit institutions and practices.

This new concept of central banking, regulatory as well as developmental, often posed a thorny problem owing to the conflict that often arises between the short-term and long-term objectives of central banking policy in the growth phase of a developing nation. The conflict cannot be resolved by the sacrifice of one function in favour of the other. For, if through undue caution the Bank withheld legitimate credit for agricultural and industrial production, these sectors might never develop. In the ultimate analysis, therefore, the Bank could not help but endeavour to bring about a reconciliation between the two equally important aspects of its role; its promotional role of developing new institutions and helping certain segments of economy in acquiring requisite credit, and its regulatory role as the controller of credit expansion in the economy.

The Reserve Bank has been criticised for getting actively involved in development functions on the grounds that it would impair its efficiency as a central banker. Its diversified activities in the development of financial institutions tend to make it a monolithic organisation with all the demerits associated with bigness. The Bank has, along with the Government, initiated the development of a number of term-lending institutions. It owns a full-fledged development bank and administers its business through a common board of directors.* It has reconstructed cooperative credit institutions and improved their working conditions. Through its Industrial Finance Department (IFD) and Agricultural Credit Department (ACD) it advises the specialised financial institutions and cooperative banks respectively. It has strengthened and consolidated the banking system of the country by virtue of the wide and extensive powers vested in it by the Banking Regulation Act, 1949. The promotional role is evident not only because it fills the vacuum in the credit structure but also because it creates a public sector in commercial banking. The creation of public sector banking began in July 1955, when the State Bank of India was born after the nationalisation of the Imperial Bank of India and culminated in the momentous decision to nationalise fourteen major Indian scheduled banks on July 19, 1969. This is indeed a remarkable change in the Indian banking structure. This development has provided the Bank with an important instrument for widening the geographical as well as functional coverage of the Indian banking system. In the

*A recent legislation delinks the IDBI from the Reserve Bank set up, see p. 184 and pp. 326-327.

postnationalisation period, there has been a new awakening in discharging the social responsibilities and obligations of the Bank. The banking system, under the guidance and supervision of the Reserve Bank, has been imbued with a socialistic consciousness, purpose, and direction. The range and variety of activities of the Indian central bank became quite different in the post-social control and nationalisation period.

Apart from its promotional and developmental activities, a central bank contributes substantially to the exchequer. The Reserve Bank of India's income, for instance, is derived from

(i) interest on Ways and Means Advances to the State Governments,
(ii) interest on Loans and Advances to the State Governments (other than Advances referred to at item (i) above and commercial and cooperative banks),
(iii) interest on Rupee Securities and discount on Rupee Treasury Bills,
(iv) interest and discount on Foreign Securities, Investments and Treasury Bills,
(v) commission and profit or gain by exchange, etc.

The Bank's income has risen from Rs 3.82 crores in 1940–41, to Rs 36.21 crores in 1956-57 and Rs 52.22 crores at the end of June 1964. During the year 1968-69 the Reserve Bank's income, after making statutory and other provisions, amounted to Rs 99.35 crores as against Rs 92.92 crores in the previous year. This phenomenal rise in income is an indication of its various developmental activities in a developing economy. The amount of net profits transferred to the Government has risen from Rs 2.62 crores in 1940–41 to Rs 30 crores in 1956–57 and to Rs 40 crores (Rs 12.33 crores being expenditure) at the end of June 1964. The net profit available for payment to the Central Government was Rs 70 crores in 1968-69 as against Rs 65 crores paid during 1967-68.[1] During the period 1963–64 to 1967–68, the Bank transferred its surplus of Rs 263 crores to the Central Government—a substantial amount from any point of view. The net profit earned by the Bank during the same period amounts to Rs 413 crores. During the accounting year ended June 30, 1974, the Bank's income, after making adjustment for various provisions, amounted to Rs 310.48 crores as compared to an income of Rs 271.29 crores in 1972–73. The contributions to Funds were Rs 115 crores during 1973–74 as against Rs 100 crores during 1972–73. Out of the balance of income amounting to Rs 195.48 crores after allowing for total expenditure amounting to Rs 50.48 crores during 1973–74 (as against the balance of income amounting to Rs 171.29 crores and expenditure of Rs 41.29 crores in 1972–73) the surplus of profit set aside for payment to the Central Government was Rs 145 crores in comparison with Rs 130 crores paid in 1972–73. The rise of Rs 39.19 crores (after deducting interest paid to the scheduled banks on the additional average daily balances maintained by them with the Reserve Bank) in the total income from the level of Rs 271.29 crores in 1972–73 to Rs 310.48 crores in 1973–74 was largely due to (i) the interest earned on foreign balances and securities because of the higher rates of interest in the USA and Europe and

[1] *Report of Central Board of Directors* for the year ended June 30, 1969, Reserve Bank of India.

an increase in the foreign exchange reserves during the year 1973–74; (ii) higher discounts earned on Treasury bills and an increase in commercial bills discounted for the scheduled banks under the Bill Market Scheme.[2]

One of the objectives of monetary and credit policy in a planned economy is to ensure that the available financial resources are allocated among the different investing sectors in accordance with the priorities of the Plan. In addition to the resources over which monetary and financial institutions exercise control, there are, of course, resources lying with households, business houses and the Government. For an integrated investment control policy, the instruments of monetary control have to be supplemented by measures of fiscal control the use of which can also be regulated according to the objectives embodied in the Plan.

An economy which is centrally planned by a totalitarian regime need not rely too much on monetary or fiscal control measures, since it can transfer resources from one use to another by decree. This sort of physical control over resources by the Government is unthinkable in a society which respects, in a large measure, the rights of private property and of private disposal of resources. However, the line between monetary and fiscal control on the one hand, and purely physical control on the other, should not be too sharply drawn. Even totalitarian regimes rely, in many situations, on measures of monetary and fiscal control instead of taking recourse to ruthless decrees involving physical control. On the other hand, even in a so-called free economy some measures of physical control may have to be introduced from time to time if monetary and fiscal controls are ineffective in realising social objectives or if their implementation involves a time lag which cannot be tolerated.

Apart from resources allocation, the instruments of monetary policy are also likely to be used for setting the aggregate money income level of the community in a desirable relation to its real income. It is now well known that no simple relationship exists between the stock of money in a community and the general price level of goods and services. This crude Quantity Theory of the relationship between money and prices has now given place to the Income Theory of the price level which takes into account the level of money income over a period and considers it in relation to the real income of either the same or an adjacent period to discover the likely effect on the price level. An inflated money income level, in relation to the prevailing real income level is likely, sooner or later, to raise prices all-around while an unduly deflated money income level will produce all the symptoms of a depression, such as lower real incomes and prices. The responsibility of the makers of monetary policy is, indeed, great. If they fail to provide for an adequate money income level, they will check the springs of real income growth. In a planned economy this runs counter to the central purpose of planning. On the other hand, if they permit money income to attain a level which the growth of real incomes cannot match, they may plunge the country into headlong inflation which will itself diminish the chances of

[2] Annual Report, 1973-74. Details of income of the Reserve Bank of India for the year ended June 30, 1975, are available in Appendix B, p. 342.

long period growth at the rate projected by the planners. An appropriate monetary policy can, by maintaining a correct balance between money income and real income growth, contribute appreciably to the effective implementation of the Plan.

It must be observed, however, that the supply of money may have to be augmented beyond the 'safe' limit under certain special conditions. For instance, where there are idle resources and excess capacity, it may be necessary to increase money supply for the purpose of stimulating output. But this argument assumes the condition of a highly elastic output in the short run which is not to be generally witnessed in underdeveloped countries. Supplies in such economies are inelastic and monetary expansion may raise prices rather than output even though unemployed resources exist. The rate of growth of money supply, however, must not fall short of that in real output, otherwise deflationary trends may set in. All this is well-illustrated in the price trends in the Indian economy during the Plan period. During the First Five Year Plan monetary imbalance was responsible for a price decline, the rate of growth of money supply being outpaced by the rate of growth in real output. In the Second Plan, however, the rate of growth of real income fell so short of the expansion in monetary resources as to generate severe pressures on prices. During the Third Five Year Plan, and more so in the Fourth Plan, the imbalance between the two rates was even greater with the result that the pressure on prices was even more severe.

The issue is whether monetary authorities in India should adopt a policy of monetary expansion in anticipation of real income growth or whether they should follow a cautious policy of monetary management issuing additional purchasing power only in response to the ascertained needs of the public. In favour of the former course there is the important argument that a policy of monetary expansion can put extra funds in the hands of the Government and private entrepreneurs who can utilise these funds to draw new productive resources into employment. Monetary expansion can thus serve as the prime mover in a process of general economic expansion. This argument is undoubtedly valid in a situation in which there is considerable elasticity in the system of production and people's spending propensities do not run far ahead of the pace at which production increases. If, however, the situation is one in which production cannot reach higher levels within a short time because existing capacity is already fully used and, at the same time, people have a tendency to spend any extra income that comes to them, the monetary authorities should do well to follow a cautious policy regarding monetary expansion if they desire to maintain stability in the level of prices. Of course, if the rise in prices is moderate there need not be any undue concern about the future value of the monetary unit; people will adjust their expectations accordingly and will take for granted a slow erosion in the value of their savings. But if, at any time, their expectations are violently upset, they may lose their poise. Apprehending that the value of money will sink continuously, they may indulge in orgies of spending, thus aggravating the rise in prices which they would prefer to see ended.

In recent years circumstances have forced the monetary authorities to finance the Government's developmental and other expenditure with an expanded supply of money. The response of the productive system to such expenditure has not been as speedy as would be desirable for economic stability and some price rise has, therefore, occurred in India as a result of too rapid monetary expansion, apart from the sectional rise in prices (e.g. prices in foodgrains) brought about by periodical shortfalls in supply associated with natural factors. In future, the monetary authorities must take greater care to see that excessive price fluctuations are avoided, although it must be admitted that when the pace of expenditure is set by the fiscal authorities, the monetary authorities are, under present-day conditions, almost powerless to stem the tide of monetary expansion.

The task that confronts India in the immediate future is to prevent the emergence of inflationary conditions in the economy. A central bank has to be constantly vigilant in this respect and its monetary policy has to be adjusted and readjusted as often as necessary towards maintaining stability of prices. The success of a central bank depends on how well its monetary policy dovetails into the economic and financial policies adopted by the Government. However, monetary policy can work successfully only in combination with fiscal policy. Monetary policy, together with fiscal policies, can assure that the growth of output will not be retarded by an inadequate growth of demand.[3] Even in developed countries such a complementary position cannot be eschewed except with unfortunate results for the economy. In an underdeveloped country, the need for this integration, is, if anything, greater. The nature of the economic problem in developing economies is such that it can be attacked only by the simultaneous employment of a package of monetary, fiscal, and physical controls. There is no mathematical formula which can draw the line between the areas of the respective operations of each of them. Indeed, there may be considerable overlapping and even conflict in the areas of their operations. In this 'policy-mix,' the role of monetary control is an important element in the overall economic policy. The success of the central banker in using the instruments available to him depends primarily on the appropriateness of the whole set of economic policies. Monetary policy, it is emphasised, cannot successfully compensate for the inadequacy of other policies. For growth to proceed without inflation, the pattern of investment in a country like India should be such as to ensure an abundance of those goods which the working classes buy—wheat, rice, and cloth—goods whose prices are of special significance to stability. In Indian conditions if there is an abundance of foodgrains, a great many risks could be taken on the fiscal and monetary front without an inflationary upsurge in prices. But if foodgrain shortages continue, not all the fiscal and monetary restraints can hold the price line. Professor Chandler rightly observes that only when a country recognises the limitations as well as potentialities of monetary policy will it be able to develop a balanced overall programme for promoting economic growth and place proper

[3] Chandler, L. V., op. cit., p. 53.

stress on the many other measures necessary for growth.[4]

The regional disparity in the growth of Indian banking has recently attracted a good deal of attention. While the overall growth rates of banking after the nationalisation have been significant from the point of view of the number of branches, total deposits, and total bank credit, the various States have, fared differently with regard to the expansion of the scheduled banks. The predominance of Maharashtra in the banking world still remains a fact. There is a heavy concentration of deposits and advances in a few States, which follows inevitably from the concentration of industrial and commercial activity in the large cities. The more developed States received two times and a half more credit than the less developed ones from the public sector banks for the development of their priority sectors. Likewise, the share of total assistance granted by the development banks to the backward areas or districts in the more developed States seems to exceed that going to similar areas in the less developed States. Nevertheless, there are indications that gradually this discrimination would lessen.

In this context, the need for having Regional Reserve Banks in India is stressed. In the USA, there are Regional Reserve Banks which cater to the requirements of the different regions; and the activities of these banks are coordinated by a monetary board known as the Federal Reserve Board which is at the apex. India is a vast country with many regions having their own peculiar characteristics; Regional Reserve Banks would be able to serve the requirements of these different regions much better than one central bank with branches in various places. The activities of the Regional Banks could be coordinated by a monetary board, as in the USA. As there are no such Regional Banks some States may have cause to complain that other States have excessive authority or too much influence in regard to financial matters. According to Professor R. S. Sayers[5] federal types of institutions in Government and for monetary management on the model of the system prevailing in the USA are required by countries like India having a large population especially when they are economically undeveloped or underdeveloped.

In most of the undeveloped countries indigenous banking has been found to be wholly unorganised. The central banker in India will have to undertake the important task of not only assisting the development of indigenous banks but also that of exercising a healthy influence on their conduct. A central bank can promote the growth of savings and a more efficient channelling of savings by developing banking and financial institutions and markets in rural India. The basic task in this regard is to promote the widest possible extension of banking facilities so that the savings of the people are mobilised to the fullest possible extent and the maximum number of financial transactions pass through an organised banking system. This extension of banking facilities would mean that banking offices must cover the entire country geograpnically; socially they must cover all strata of the population and functionally the various facets of the economy.

[4] Ibid, p. 54.

[5] Sayers, R. S., *Modern Banking*, Oxford University Press, London, p. 296.

The innovation of a 'one-man office' is a bold banking experiment in rural areas which, with its threefold objectives of reducing the cost factor, providing banking services and mobilising deposits, will prove to be a contribution of real value to the promotion of rural banking in the country. The fusion of banking with the rural setting which is a complex of many sentiments, prejudices and suspicions, is urgently required if the banking sector is to make a positive contribution to economic growth. The measure of success in attaining the social objectives of economic planning in India can broadly be taken to be, in the ultimate analysis, the extent to which the benefits of a rising standard of living and prosperity percolate to the people inhabiting th semiurban and rural sectors of the country. A challenge exists and must be accepted: to forge a link between the pile-carpeted air-conditioned office of modern Indian banks and the mud-walled, thatched huts of the sun-scorched dung-dotted villages of India.

While modern commercial banks have existed for more than a hundred years in India, the fact that not even 2 per cent of the population has had anything to do with them in the capacity of depositors or borrowers bears testimony to the relationship between the common man and banking. The expanding credit needs of the priority sectors like agriculture, small industries, exports, etc. of the economy call for vigorous efforts towards the mobilisation of savings and bank deposits constitute the most important form of savings. No doubt, the past few years have witnessed a notable rise in deposits and the total deposits of scheduled banks as a proportion of the monetary resources (currency plus deposits) now stand at 55 per cent as against 38 per cent in 1951. Even so, the proportion of currency remaining outside the banking system is very high by international standards. This is largely due to the inadequate growth of the banking habit and the fact that a large part of the rural areas are still untouched by commercial banks. There is no escape from the situation that unless the banks resort to aggressive marketing to augment deposit resources, the objectives of bank nationalisation will not be fulfilled.

The various aspects of deposit mobilisation succinctly are that:

It was accepted that the commercial banking industry will benefit greatly from the adoption of marketing concepts;

Marketing is the discovery of what the customer wants and what he would need in future;

Among customer-satisfying services the most decisive is the quality of service;

Banks should classify depositors according to sections and take intensive measures to market their services;

Promotion of the banking habit by devising schemes to suit sub-markets and attract them by suitable media of publicity;

The various techniques of banks are based essentially on the principles of Mobility, Flexibility, Convenience, Reduction of Cash Drain, Automatic Facilities and Special Inducements;

Facilities imparting mobility were recognised as very important in deposit mobilisation from rural areas. Provision of conveyance facilities to the staff of rural branches was an important step in this direction;

While one man offices served a useful purpose banks should work towards opening full-fledged branches in the rural parts to provide all the necessary services to the village population;

The staff for the rural branches of the banks should be chosen from ambitious young people with enterprise;

Banks should pool their experience regarding the various schemes tried out by them so that the successful ones could be identified and improved upon.

The various schemes devised by commercial banks for deposit mobilisation revolve round the following fundamental principles:

Mobility—which helps the banks to reach out to new sections of customers, e.g. Mobile Van Scheme, Mobile Bank Schemes, Itinerant Agents Scheme, Small Deposits Scheme, One-Man Offices, etc.

Flexibility e.g., morning and evening branches, night depository services.

Convenience to customers e.g., convenient location as in residental areas, shopping centre branches, etc.

Automatic facility e.g., In-Plant Scheme.

Reduction of cash drain by offer of near-cash instruments, like travellers cheques, guaranteed cheques, etc.

Special inducements to depositors, e.g. savings promotion campaign, savings weeks, etc.

The efforts of banks should be directed to bringing into their fold a larger portion of the total money supply in the country. The nationalised banks can enter in agency arrangements so that they can draw on each other in times of need. In order to facilitate quick transfer of funds the feasibility of the Giro System should be explored by a small study group.

A rational distribution of branches over a wider geographical region is imperative to correct the present imbalanced growth. Branch expansion on a large scale calls for careful planning of the manpower resources of the banking industry.

The information system, so far, has been geared to generating information for transactional decisions. It is necessary that in the changed context information flow be geared to decision making for purposes of planning, coordination, control, and evaluation of marketing policies. A clear definition of the roles, responsibilities, and relations within a banking organisation is a precondition for determining information requirements for effective deposit mobilisation strategy.[6]

The rapid growth of commercial banks in the country, coupled with the increasing complexity of banking functions, has rendered the decision-making task of a bank manager one of the most difficult imaginable. A banker today is required to make a host of decisions in a fast-changing environment about which very little concrete data are readily available. It is not possible for him to improve the quality of his decisions without some external inputs in the form of tested principles and techniques. It is here that operations research can

[6] For an excellent analysis see Das, Tushar K., (i) *Operations Research for Decision Making in Commercial Banks*, NIBM, Bombay, 1972; (ii) *Deposit Mobilisation*, National Institute of Bank Management, Bombay, 1970.

be of great assistance as it has the appropriate approach and methods for better decision-making.

Shuchman[7] has stated that operations research promises to convert many complex problems to ordered patterns which can be analysed with a vast variety of tools widely used in other disciplines. It promises, therefore, to give managers new insights into the fundamental nature of problems to determine better solutions with greater speed and assurance.

While enough potentiality of deposit mobilisation is evident, it is further pointed out that the huge developmental outlay in the Fifth Plan, rapid monetisation of the economy, the lowering of personal taxation, and the expected stabilisation of the prices of agricultural commodities are the seeds for the growth of deposits. What is needed is a proper effort by the banking system to gear the machinery for it to be forceful enough to attain the purpose. A well-conceived programme of rural branch expansion, a well-knit frame of mobile banking, educative publicity and careful adaptation of procedures will tend to be strong motivating forces. Indeed, efficiency in mobilisation of deposit is the linchpin of the banking business. An important task of the central banker in an undeveloped money market is, thus, to bring more and more untapped rural areas within the orbit of the organised banking sector.

Regarding the problems of rural credit some new requirements that remain relatively unfulfilled by the institutional structure are a much larger demand for credit, a shift towards long-term credit, and the need for providing credit for the small and less privileged cultivators. The need of the small farmers and marginal farmers is most urgent. One of the remedies lies in shifting the emphasis from land to produce, from property to production, and to link the prospect of larger credit to the promise of higher income from farm plans and projects.

The growing threat to the whole system of cooperative credit is the intrusion of politics into the business affairs of cooperatives as it seems impossible to keep them immune from politics. Politicalisation, it is feared, beyond a degree is bound to kill both process and system.

The commercial banks need to come out of the hitherto conservative fold with the active stimulus provided by the central monetary authority in matters of bank credit. The credit squeeze that has recently made its impact on bank credit seems to be neither conducive to a healthy economy nor wholesome for economic expansion. What is necessary is not a conservative approach to bank credit but a breadth of vision and boldness of approach. And this requires considerable judgement and prudence in the application of bank funds in different segments of economy to ensure development on an even keel. In the context of competitive demands for bank funds, priority has got to be determined on a very pragmatic consideration of development projects and fields of investment. While the central planning authority will indicate the priority sectors, the stupendous responsibility of providing guidelines to the banking system in its credit operations rests squarely with the central monetary authority.

[7] Shuchman, Abe, Ed., *Scientific Decision Making in Business*, Holt, Rinehart and Winston, Inc., New York, 1963, p. 9.

A liberal loan policy, however, calls for a judicious investment portfolio of the commercial banks to ensure availability of necessary funds to cater to the needs of credit. Seasonal variation in the Indian economy, a great fluctuating factor in investment pattern, is gradually lessening with the rise of industrial economy. Lately there is an evident swing of bank investments in medium-short securities, possibly in order to keep the liquidity in readiness to respond to the demand for bank funds in a developing economy. However, the statutory obligation of keeping a very high percentage of deposits in Government securities and non-yielding assets tends to tie the hands of commercial banks in the matter of extending larger credits as a substantial portion of deposits is left unutilised. While it is emphasised that availability of adequate funds to the commercial banks needs to be ensured to meet the demands for credit, a reasonable check, however, on the pattern of operational behaviour has got to be maintained in order to protect bank funds against wanton waste and misapplication. Social gains should receive the topmost consideration from bank finance. The central bank can use selective controls, along with other Government measures, to divert savings and capital away from uses in which they will contribute less to economic growth, toward uses in which their contribution to growth will be larger.[8] But experience in India shows that this weapon has been less effective than expected and the measures of the selective controls were honoured more in the breach than in observance. There is ample evidence to show that central banking orders were flouted for promotion of sectional interest and professional gains and not for overall advance of the national economy. Because of the absence of effective supervision of the end-use of credit and the possibility of circumvention through recourse to the unorganised money market, these controls suffer from some inherent limitations.

One of the defects of monetary policy is the existence of the unorganised monetary sector and urgent steps are necessary to correct the position as, otherwise, weapons of the central bank would not only tend to be ineffective but would also be, in effect, discriminatory in character. Whereas the commercial banks are in the shackles of the regulatory processes of the central bank, the unorganised sector being out of the orbit of the central banks' direction and control can have its own sway and this feature has assumed alarming proportions. There are already some checks provided for in the recent regulatory measures but more stringent measures need to be introduced so that the regulatory directives become applicable to organised and unorganised sectors alike. The eventual integration of the organised and unorganised sectors, will make the money market sensitive and responsive to the monetary policy. It should be made clear to the unorganised agencies that it would be in their own interest, as well as that of the economy, to modernise their practices and methods. Viewed against the overall developmental needs of the economy, any step taken must not seek to eliminate (assuming that is possible) these agencies. As some elements of the old institutions are conducive to development, progress would be quicker if the development of new institutions supplemented the existing ones and even forged links

[8] Chandler, L. V., op.cit., pp. 53-54.

with the old ones. Around one third of the Indian economy is represented by the subsistence sector, where saving, investment, and other transactions are conducted without recourse to money. The size of the sector is likely to shrink, although it is difficult to specify the rate of monetisation. Supplantation of the subsistence sector helps raise the growth of the economy.

There should exist reasonable mobility of funds from one submarket to another. A movement in one sector should immediately affect the position of all others. The whole organisation of the money market should be an integrated structure. This sort of integration is ably brought out in Mr Sykes's comparison of the London money market to a wheel, whose axle is the Bank of England, the hub of the wheel is represented by the joint stock banks, the spokes by the other banks of the country, the rim by the discount houses. In a highly integrated structure, when the central bank touches one spot in the market, the rest will react to the stimulus. Dr Sen rightly remarks that the whole of the money market is a single credit pool in which whenever the central bank flings a stone, the waves will gradually reach all shores.[9]

The regulation of the access right of the banking system to the central bank credit *vis-à-vis* its liquidity position is an interesting study in the recent banking trends of India. The upward trend of interest charged on the scales of borrowings unmistakably indicates the Reserve Bank of India's growing concern about keeping the money supply within safe limits in order to curb the resultant adverse effect of inflation due to an excess of money. The persistent rise in credit expansion by resorting to increasing borrowings proves adequately that the quota-cum-slab system of lending policy had little effect on borrowings by the banking system. The deployment of a new controlling device was, therefore, called for by which the borrowing power of the bank was related to its net liquidity position. The more a bank borrows to lend to its customers, the more it has to pay to the Reserve Bank of India. At one time different banks will be paying different rates of interest depending on their individual liquidity position. It is, thus, designed to impose a restraint on heavy and prolonged use of such credit. By directly raising the borrowing rate and increasing the penalty implied in a higher liquidity ratio (from 28 per cent under the September 1964 Scheme to 39 per cent with effect from July 1974), the Reserve Bank of India further raised the cost of credit and regulated the access right of the banking system to the central bank. Despite such measures to regulate money supply and credit, an increasing trend of borrowings from the Reserve Bank of India went on unabated largely owing to the increasing demand for bank funds in the wake of development under the planned economy. In fact, the Reserve Bank of India's approach to the matter does not seem to be in keeping with the developmental tempo. The Reserve Bank of India should not only have introduced measures of control over the volume of money supply, but more importantly, should have kept a watch on the application of bank funds in really productive fields also. But this was sadly lacking. The recent trend, however, towards liberalisation of bank credit in the priority sectors, if properly cared for, will create a healthy banking business

[9] Sen, op. cit., p. 21.

and a self-sustaining growth. The raising of the bank rate from 3.5 per cent in 1951 gradually to 9 per cent in 1974 indicates the trend of making credit costlier step by step. It must, however, be observed that the bank rate forms only a small segment of the whole interest rate structure which regulates the flow of funds to different sectors. Even monetary commissions of international repute, like the Radcliffe Committee, have expressed their mixed feelings regarding the potentiality of this instrument. The importance of the bank rate in the Indian economy is further whittled by the fact that it relates only to the borrowings of the scheduled banks from the Reserve Bank of India. To ensure that the flow of funds to different sectors or to different uses is in accordance with the Plan objectives, this sphere of regulation has, necessarily, to encompass the whole structure of interest rates.

A large number of development banks mushrooming in India all with duplicating functions and their overlapping in the fields of industry and agriculture to the utter neglect of rural economy is a disquieting trend. Disappointment over the direction of growth of development banking is strongly felt as the impact on the quality of life of the rural sector has been marginal. The predominance of the large-scale sector in the matter of getting financial assistance is another distressing fact which offends the concepts of social justice. The ICICI is significantly ahead, the IFCI mid-way and the IDBI last in the degree of assistance granted to the large industrial sector in contributing to this injustice.

The spectacular growth and development of financial institutions under the auspices of the Reserve Bank of India has added a new dimension to central banking theory and practice. The structure and functioning of a development bank must have the capacity to respond to new challenges with innovative ability. The IDBI should continue to function as an independent institution, immune from the shifting opportunistic pressures of competitive politics. The Reserve Bank has in addition to the traditional role of a central bank branched out in new areas of activity. It is feared that a wide diversification in the developmental activities may lead to a sheer 'dilution' of the essence of central banking. As the economy grows more and more mature, the central bank, already overburdened, should shed its non-central banking functions and operate as a distinct institution.

It is, therefore, but natural that the Reserve Bank of India which, at earlier stage of planned economy, had to assume a diversity of roles, should now gradually abandon its non-central banking functions and restrict itself to purely central banking business. The Reserve Bank, as the central bank, is primarily concerned with the control and regulation of the short-term money market whereas the principal objective of the IDBI is to supply long-term industrial finance. The restructured IDBI would now concentrate more on improving on its past performance in stimulating further industrial growth. Steps should be initiatied by the restructured Board to streamline and rationalise the organisational set-up with appropriate delegation and decentralisation of powers so that it can more actively involve itself in the rehabilitation of existing industries and removal of regional imbalances. This vital institutional innovation—delinked from the Reserve Bank set-up—can now formulate policy decisions and

frame suitable guidelines for the administration of industrial loans independent of partisan politics and pressure groups. It is expected that the newly constituted IDBI—divorced from short-sighted political advantage—will usher in a new era in the industrial structure of India.

There seems to be little logic, particularly in an emerging economy, to shut out the commercial banks from the area of development finance earmarking the field only for the specialised institutions. It is an outmoded line of thinking inasmuch as the developing economy has a definite claim on bank finance. What is really necessary is active encouragement from the Reserve Bank of India to the commercial banking system to tread this hitherto forsaken track to bring about overall development; but some demarcation may be made as to the areas to be served by the development banks and the commercial banks. The gigantic, promotional projects which have inadequate security and a long gestation period may be served by the development banks by providing development finance on a long and medium term basis. Development banks would be well advised to go in for long-term financing (for loans above 10 years' maturity) and where risks are far more commensurate with profit yield. The calculated risks of term loans up to 10 years based on adequate information, judgment, and analysis should, however, be borne by the commercial banks in the interest of the planned economic development of India. Development banking connotes not only financial assistance but also initiative, skill, and technical opportunities to bring about an all-round development of national economy. There is, indeed, a cogent reason for opening up the development areas to the commercial banking system of India. A more purposeful advent of commercial banks in term credits is bound to bring them into closer relationship with development banks. It will be helpful to both to have a mutual understanding about their respective operations.

This is not to decry development banks altogether. In a developing economy the flow of financial assistance for economic development has to be routed through many channels and development banks constitute an important channel. Although development banks cannot take the place of a healthy capital market, they can at least make some contribution to the growth of a capital market. The general strategy for economic growth, fiscal and monetary policies, and the framework of the corporate law and other legislation concerning the investment market must all be such as to create and sustain investors' confidence so that savings may be generated in a big way and invested for economic growth. The entrepreneurs have an obligation to establish and manage enterprises efficiently and honestly to inspire such confidence. In these matters, too, development banks can play a useful role.

The export economy has got to be boosted up by lending the support of bank credit to strengthen the economic base of the country. The role of the Reserve Bank of India in export promotion has assumed added importance in the context of greater emphasis laid on export growth. Export trade as a stimulator of investment and growth can provide the less developed countries enough investable resources for a self-sustained economy. In order to ensure that India is not dislodged from the export markets which she may have some chance

of exploiting in the future, the Reserve Bank of India must examine seriously, at this stage, the question of making its refinancing terms sufficiently attractive by falling in line with her counterparts in foreign countries. The emphasis on the expansion of export should be on the provision of larger export credits on better terms in order to achieve the expected level.

The large reduction of the concessional rate of interest in respect of export finance, apart from the bank rate and other concessional rates, will impress the exporters and the bankers as well as the public as a whole, that the Reserve Bank now takes a firm and decisive stand in promoting exports. The guidelines issued by it to the commercial banks in regard to their normal operational behaviour should be kept under continuous scrutiny to ensure that they do not constitute bottlenecks in the drive for export promotion.

The Reserve Bank may also take the initiative in holding periodical conferences in which persons interested in monetary, financial, and business problems can meet and exchange ideas. It would also be desirable if the Bank makes it a point to consider the advice of the commercial banks, cooperative banks, etc., before formulating policies; for, however talented the Central Board of Directors may be, it would profit by consulting others. Besides, it should have firsthand information about the problems and difficulties faced by the various credit institutions and the views of the representatives of these institutions on monetary and financial problems. There are Advisory Councils in the other countries like Australia and Germany to give their views to the central bank on monetary policies. In the USA, the banks are represented on the Federal Reserve Banks and the Open-Market Operations Committee of the Federal Reserve Board. In the UK also, there is provision for consultations between the Bank of England and the leading joint-stock banks. The central bank should, moreover, constantly strive to bring about simplification, uniformity and standardisation in banking techniques and practices to facilitate expeditious and smooth financial operations pertaining to national and international trade and commerce.

The provisions of the Banking Regulation Act with regard to minimum adequacy of banks' capital funds which were introduced in the pre-Plan period became outmoded with the remarkable diversification of activities under the Plans and the vigorous expansion of both deposits and credits. The Act was amended requiring every bank to transfer 20 per cent of its profits to reserve even after it equals the paid-up capital (Section 17). A norm has been set up by the Reserve Bank of India that it may exempt a bank from the provision of this section if the ratio of paid-up capital and reserves reaches 6 per cent of the deposits. If this convention is practised in the right spirit, the regulation will improve the tone and efficiency of the banking system by strengthening the capital base of the banks.

The specification of the percentage of net profit to be carried to the reserve fund until i reaches a stated ratio to capital is a notable feature of most banking legislation. The minimum proportion of net profit to be carried to reserves is found to range from 5 per cent in Turkey and Switzerland to 20 per cent in Norway. The provision of the Indian legislation, thus, seems

to be the most stringent of its kind with the exception of Norway.

The fixed legal minima are hardly effective in promoting bank liquidity. That the composition of the liquid assets as envisaged in the Indian legislation is defective can be illustrated by reference to the position of the smaller banks and rural banks (suggested by the Banking Commission) whose advances are principally made for financing seasonal agricultural operations. It is emphasised that the capital-assets (realisable value and not balance sheet value of assets) standard which is being increasingly adopted in recent banking legislations is more scientific than the outmoded capital-deposits ratio.

The 39 per cent liquidity requirement* of Indian banks is considered to be high particularly when demand for credit is growing. The new liquidity requirements, it is feared, may result in depriving the developing sectors of the much needed bank finance. New legislation would compel the banking system to invest its resources in less productive Government securities, preventing expansion of credit to more productive sectors, which will offend the investment principle of growth economy. The time-honoured concept of liquidity loses much of its sanctity in a developing economy in which the solvency of the banking system becomes identical with the economic efficiency and solvency of the Government itself.

The overall domestic banking policy followed by France in the last few years consists of placing the element of competition and freedom at the service of the much needed economic expansion. Similarly, in West Germany also the central banking authorities removed fixation of advance and deposit rates for its banking system. The Bank of England, too, has hardly utilised the powers conferred on it under the Bank of England Act of 1946. Central banking authorities in India also should utilise, as far as possible, the interplay of free competitive forces to determine flow of credit to various channels. An element of competition between the private sector and public sector banks in India would perhaps make both the sectors efficient, progressive, and useful to society. However, the scope for readjustment in the existing pattern of credit distribution is limited.

With the development of term lending by the commercial and cooperative banks and by the various specialised institutions for industrial finance, India has now a fairly well-articulated financial structure, capable of responding more efficiently, if not fully, to the growing demands of the developing economy. There are still, it must be stressed, deficiencies and shortcomings to be overcome. Nevertheless, it is significant that over the last 25 years of planning, institutional finance has substantially replaced the old, traditional system of money lending. The institutional developments sponsored or assisted by the Reserve Bank over the last 25 years of planning, the imposition of social control, and nationalisation of banks have prepared the basis for the new orientation that is being initiated in the direction of a more purposive and more concerted move towards bringing the whole economy within the ambit of modern banking services.

* The mechanism has been replaced in the 1975-76 busy season credit policy.

There is, however, urgent need for change in management responsibilities, social obligations, and attitudes of the central bank in the context of bank nationalisation. A central banker in the post-nationalisation period is not just a purveyor of funds, but an innovator of economic and social change in the altered economic perspective. For this he has to take a lot of initiative as well as larger risks than he was accustomed to take yesteryear.

The quantitative aspects of the progress of public sector banks are significant. The fast rate of expansion of banks, both in the geographical sense and in terms of diversification of activities, requires some basic changes in organisation structure and decision making process, manpower requirements, training needs, methods and systems, procedures and practices, and above all in attitudes and aspirations. Credit dispensation is a delicate decision, for it is not easily amenable to standardisation, more so when ensuring repayment of credit dispensed is considered an essential part of credit decisions. This makes the task of bank management a difficult and complicated one which can only be achieved through ingenuity, innovativeness, and a high degree of risk bearing capacity. It is the understanding of this new qualitiative and positive content that nationalisation has imparted.

Credit dispensation has to be supervised to ensure end-use so that credit leads to an increase in the income of the recipient. Supervised credit dispensation presupposes the rendering of a high degree of noncredit assistance, (e.g. marketing of output, etc.) by the banker to his priority-sector borrower. The new breed of banker required is one who is not only a credit dispenser, but one who must provide a wide range of noncredit services. To the extent that rendering such noncredit assistance can be institutionalised by agencies other than banks, the bankers' task becomes easier. In quantitative terms the achievements of the public sector banks are inadequate in the context of the expectations and magnitude of the needs of society. Banks have achieved a considerable telescoping of time but it is not adequate. Continuous efforts have to be made to telescope time still further, while retaining the credit character of banks. The concept of bank lending, the method of loan appraisal, the emphasis on additional production rather than on the assets offered as security while sanctioning new loans or additional limits, etc. have brought about far-reaching qualitative changes. The rural branches function as the nuclei, mobilising surplus funds generated in the rural areas and providing credit needed by the local community. The new approach to lending contributes to financial discipline among borrowers and reduces the scope for unproductive use of bank credit. What is more remarkable is that the new process applies to all loan applicants—big industrialists and small enterpreneurs. Nationalisation was designed to give the Government control over the 'commanding heights' of the banking system so that its resources could be deployed in a manner which subserves the larger good of the community. In this respect, credit provided to the Food Corporation of India to enable it to purchase foodgrains and distribute them more equitably, credit facilities to the oil companies, electricity boards and rural electricity corporations are very commendable services.

The deterioration in the quality of banking services since nationalisation has often been criticised. A choice between quantitative expansion and qualitative efficiency became inevitable and, naturally, the former took precedence over the latter. The Reserve Bank has to appreciate that the complexion of the problem has changed beyond comprehension during the last six years. Meanwhile, efforts to gear up the administrative machinery of the banks to face the challenge should continue. The new style banking imposed much larger responsibility on bankers, including the central banker, just when they are inadequately equipped for this onerous task. It is no wonder that they become objects of criticism from borrowers as well as the general public. The question likely to be asked is whether there was any need at all for setting up rural banks, when the nationalised banks had already extended their activities to rural areas and also in view of the existence of cooperative banks.

The entire programme of bank expansion in the country is likely to undergo substantial modifications following the establishment of regional rural banks. The Reserve Bank of India should institute a review of the present 'lead bank' programme and its branch licensing policy to avoid conflict with the growth and activities of the regional rural banks and the expansion of commercial banks into rural areas. The review will pave the way for the reallocation of 'lead bank' responsibilities as well as the modification of the Reserve Bank's branch expansion policy. The experience of the regional rural banks shows that the branches of the new rural banks were opened in the centres where the 'lead banks' had already prepared the grounds for opening new branches. With the rural bank emerging as the main farm credit agency of these areas the role of the 'lead banks' has become subsidiary.

In a developing economy central banks can make a valuable contribution in their capacity as financial advisers and advisers on foreign exchange policy to their Government. Professor Sayers has emphasised this aspect of the role of the central bankers when he says that "they have been extremely useful as advisers on these matters and as the technicians who could conveniently undertake foreign exchange operations".[10] By virtue of their close and continuous contact with the markets and by virtue of their enterprise they are undoubtedly best qualified to advise the Government on all economic and financial issues. Again, it is the uninhibited advice of an impartial observer whose judgment is not warped by considerations of sectional or vested interests. The responsibility for this function has been specifically written down into the statutes of the central banks. The central bank must, however, be careful not to dabble in matters which might have political implications. It ought to confine its advice to financial and economic issues on which it is qualified by virtue of its technical competence.

The central banker, with his 'wise leadership and high principled action', should aim at securing the active and continuous cooperation of the commercial banking system and increasing this moral influence over other financial

[10] Sayers, R. S., loc. cit., p. 114.

institutions and the business community at large. Dr De Kock[11] had this to say on the subject :

> With its leadership of the financial system well established and willingly accepted and its actions and warnings heeded by businessmen, because by experience they have found it to be in their interest to do so, the central bank has more than half its battle won.

The affairs of central banks have to be managed efficiently and effectively as the operations of a central bank vitally affect the entire economy of the country; and it is here that the need for having well-trained and talented central bankers assumes great importance. In some countries which have undeveloped money markets such as Australia and South Africa, there have been able Governors who have had not only theoretical knowledge but also practical experience; and this has contributed to the success of central banking operations in those countries.

Besides an able Governor the central bank should also have a number of talented officers; the departments of Banking Operations and Development, Agricultural Credit, Industrial Finance, and Research and Statistics must be specially manned by personnel of a very high calibre. Ultimately, the working of a central bank depends not merely on its Governor but also on the quality of the staff working under him; and even a talented Governor may find it difficult to work the Bank efficiently if the officers under him are not quite up to the mark.

It is felt that the Reserve Bank lacks manpower of the right quality and that much better conditions might have prevailed if there had been good and talented personnel managing its affairs. The task of finding and training adequate personnel to carry out successfully the operations of a modern central bank is now going to prove more important than the search for any more new gadgets of control.

The Fifth Plan is a much bigger one in size than the previous Plans and the Reserve Bank will probably have to face added responsibilities in the coming years to provide more funds to the Government either by means of loans and advances or investments. It may also have to take a greater interest in the development of banking facilities in order to mobilise resources and provide a larger volume of credit.

The Reserve Bank has been in existence for about four decades; and during this period it has some achievements to its credit. It has provided the Union Government and the State Governments with the finances which they require for purposes of development and has contributed to the development of sound banking in the country. From the actual working of the Reserve Bank, there is justification for the claim that a new epoch of financial stability, banking reform and extension and reorientation of the money market has been inaugurated by it. In absolute terms the contribution of the Reserve Bank went up in Government credit and commercial credit and in building up foreign exchange assets during the Third and Fourth Plan periods.

[11] De Kock, loc. cit., p. 159.

The central bank of a country can be developed only gradually as is evidenced by the fact that it took more than two hundred years for the Bank of England to develop and reach its present position. Naturally, in India also, it would take a number of years for the Reserve Bank to develop fully, function effectively and attain eminence. An outstanding task for the Reserve Bank in the coming years remains one to promote the building up of a banking structure which is adequate in scope and range, with diversified enough forms of financing institutions to meet the various kinds of credit needs, and much more widely extended in geographical coverage to the rural hinterland of the country than it is today.

An important addition to the range of central banking functions in the context of developing a modern banking system is in the field of banking education. The training of banking personnel represents investment in the building up of sound banking traditions as also investment in human capital. The investment in education is the beginning of a new trend where the Reserve Bank will extend its operations to other areas of social development. A certain percentage of profits from the nationalised banks may be set apart for sponsoring chairs at the Universities for conducting research work in money, banking and finance. In the course of its investigation, the Banking Commission found that the banking field has generally been neglected by research workers. The Commission itself sponsored a number of research projects and found the effort very useful. Environmental studies too have a direct bearing on banking and there has to be constant liaison between research and education on banking proper and environmental research of a broader nature. It is emphasised again that with the increasing role of banking as an instrument for planned economic development, appropriate steps need be taken to organise research in banking education.

Most of the banks have instituted training institutions for their staff. It would not be incorrect to say that these training colleges of different banks are run as departments of the banks in a bureaucratic manner. There should be a free atmosphere in these institutions so that training and learning is encouraged along with independent thinking on banking and allied problems. These institutions ought to be given a fair measure of autonomy. The head of such an institution should be a man of high academic eminence in the field with an established reputation as a resourceful and successful teacher and an organiser in his subject. It is necessary to encourage independent thinking by the staff at the outset—at the stage of training. It would be good if the officers of the bank are encouraged to be in touch with current banking trends and developments by taking active part in discussions, seminars, and conferences connected with banking and allied disciplines. This would give them a freshness of outlook and understanding useful in carrying out their duties. Unfortunately, because of their bureaucratic attitudes bank officers usually frown upon the idea of attending such discussions or seminars much less participating in them. It is pertinent to point out that in recent discussions on inflation, bank officers showed mere formal courtesy to active participants, but avoided discussions for reasons best known to themselves. There is

considerable scope for a continuous flow of new ideas in the development of banking in the country, as well as room for eliminating weak points by a continuous independent review of its activities. In a democracy public institutions should be open to public scrutiny and public criticism.

The Indian institution, as compared to that of Ceylon or those of other underdeveloped countries, enjoys a greater degree of autonomy; yet its connection with the Government seems closer than that warranted by the principles of democracy and freedom. The Reserve Bank has been enjoying the lead it acquired as a spokesman on national monetary policy since 1947, but it has gained neither the independent status of the Federal Reserve System nor that of the Bank of England from among the advanced democracies of the West. The Reserve Bank of India is only functionally responsible for policy decisions and its execution in the monetary field. The authority in policy formation virtually lies with the Government. Unlike the USA where "processes of policy determination are surrounded with carefully devised safeguards against domination by any special interest group,"[12] in India it appears that not only policy formation but even administration in the field of money and credit have been made subject to frequent Government intervention. In a totalitarian country which has Government control over the entire economy, the existence of a central bank outside the Government is superfluous. But in the free world of democracy which combines Government control with private enterprise in its system, the separate entity of a central bank and division of monetary responsibilities between the central bank and the Government are justified necessities. The very principle of democracy in India demands autonomy of the Reserve Bank and its stay outside the direct jurusdiction of the Government.

The process of economic growth is a complex of political, social and institutional factors operating on the economy; and economic development is paradoxically not so much the result of economic as of broadly political and social factors. The growth of population, political power and Centre-State relations, rural caste and community groupings, and tenant-landlord relationship have greater relevance to economic growth than investment-income relation indicates. The central bank, however, has little control over these noneconomic factors. Moreover, since 1967 the dangers of political polarisation and instability have become apparent in India. A Government which generally is not sure of its position, or feels unable out of weakness or lack of confidence to frame the right policies and is constrained only to do whatever is politically easy, is at best a weak Government. It becomes prey to the changing moods of Parliament and tries to be content with the least common denominator. The Government's weakness will also be exploited by different pressure groups in Parliament who might well try to exert pressures to influence central banking policies in their own favour—no matter what the side effects might be.

The central banker today is a public servant as well as a banker. His role is to operate one of the instruments of public policy for the attainment of the economic objectives of the community. He does not have a separate set of

[12] The Radcliffe Committee, Memoranda of Evidence, Vol. 1, p. 294.

objectives of his own, though he must seek to influence the articulation of the community's objectives and the combination of policies chosen to attain them. He must also seek to reconcile his own and his country's policies with those of the other members of the world community. With the introduction of the scheme of SDRs and the creation of international liquidity the seeds of the future world central bank have been sown. The attempts at international financial cooperation have, however, been largely palliatives. The requirements for an international central bank are technically simple yet politically formidable.

Policies imply politics and political processes. The central bank as a policy agency must fit into the political structure and the task of ensuring this lies with professional economists. One interested in central banking policy must, therefore, be concerned with what the central bank is as a political institution as well as what it does in the area of monetary affairs. Independence of the central bank is within the Government and not of the Government. Independence in the discharge of functions depends upon the personality, courage, and wisdom of the Governor. Experience in both the developed and developing countries has shown that the relationship between the Government and the central bank is very delicate and sensitive. There can be no set pattern of ideal relationship but it is imperative that in view of the development objectives, an amicable working relationship should exist and be continually evolved and maintained in the best interest of the economy.

It is not surprising that the profession is full of interest but it is not free of uncertainty and anxiety. According to Professor Chandler, a central banker will be a better citizen, if from the beginning he sees his profession in its broad economic and social context and understands both the effects of his own actions on the functioning of the economy and the effects of Government monetary and fiscal policies.

A central banker must take a long-term view, he must sound warnings and take flexible action at times when inflationary dangers are still in a developloping stage. In order to succeed the central banker must have the courage of his convictions and be prepared to take a firm stand. The role we want him to play adequately calls for the serenity to accept what cannot be changed, the courage to change what should not be accepted, and the wisdom to initiate a change that may be necessary in the long run. As Professor Chandler says:

> To state these general principles is easy. To translate them into specific programmes and to implement those programmes will challenge the best minds and efforts of the world for years to come.

In reality, the central banker in a strong position as the most powerful man is a rare and rather temporary phenomenon. More frequently, he feels too weak to carry out his role vigorously, specially when he has insufficient independence from the Government, when the monetary instruments available to him are not strong enough, when his monetary measures are not backed by fiscal policy or even counteracted by it, and when he feels alone because he does not get enough support from the public and the politicians who take a shorter view.

Although the role of the central banker has become more demanding, it is of the utmost importance and will inevitably exercise more influence than it did earlier. There may be economic weaknesses in every economy that cannot possibly be cured by a wise monetary policy, but on the other hand healthy economies can be impaired, not only by unfortunate central bank action, but also by a lack of action.[13] In the words of Professor Chandler,[13] again,

> ...inadequate monetary policy can seriously retard growth. On the other hand, even the most powerful monetary policies can never be a substitute for the many other economic and political measures necessary for growth.

[13] *The Per Jacobsson Foundation Lecture* at Rome on November 9, 1966, "Commentary" by Mr Marcus Wallenberg, Vice-Chairman of the Board, Stockholms Enskilda Bank.

Appendices

APPENDIX A1. Reserve Bank of India
Issue Department

(In lakhs of rupees)

Last Friday/Friday	Liabilities			Assets			
	Notes held in banking department	Notes in circulation	Total liabilities (total notes issued) or assets	Gold coin and bullion	Foreign securities	Rupee coin[1]	Govt. of India rupee securities
	1	2	3	4	5	6	7
1960-61	784	198,474	199,259	11,776	12,301	11,962	163,220
1965-66	2,486	286,636	289,121	11,589	9,505	9,400	258,627
1969-70	2,338	384,256	386,593	18,253	33,142	6,463	328,735
1970-71	959	421,177	422,136	18,253	27,342	5,167	371,373
1971-72	1,813	463,718	465,531	18,253	23,865	3,627	419,785
1972-73	1,875	525,345	527,220	18,253	17,165	866	490,935
1973-74	3,314	612,654	615,968	18,253	14,174	507	583,034
1974-75	4,193	618,997	623,190	18,253	12,174	1,227	591,536
July 1974	4,877	620,747	625,624	18,253	16,674	1,386	589,311
Feb. 1975	3,649	610,808	614,457	18,253	12,174	1,497	582,534
Mar.	4,193	618,997	623,190	18,253	12,174	1,227	591,536
Apr.	3,668	644,682	648,350	18,253	12,174	886	617,038
May	2,609	658,246	660,855	18,253	12,174	890	629,539
June	1,688	658,380	660,068	18,253	12,174	601	629,040
July 4, 1975	1,246	658,127	659,373	18,253	12,174	408	628,539
,, 11, ,,	3,254	657,072	660,326	18,253	12,174	361	629,539
,, 18, ,,	4,560	645,505	650,065	18,253	12,174	599	619,039
,, 25, ,,	4,564	630,360	634,924	18,253	12,174	958	603,540

Note: The gold reserves of Issue Department are valued at Rs 53.58 per 10 grams up to January 31, 1969, and at Rs 84.39 per 10 grams thereafter.

[1] Including Government of India one rupee notes issued from July 1940.

Source: *Reserve Bank of India Bulletin*, July 1975.

APPENDIX A2. Reserve Bank of India (*Contd.*)
Banking Department

	Liabilities								
	Deposits								
Last Friday/ Friday	*Total*	*Central Govt.*	*State Govts.*	*Scheduled commercial banks*	*Scheduled State Cooperative banks*	*Non-Scheduled State coperative banks*	*Other banks*	*Others*	*Other liabilities*[2]
	8	9	10	11	12	13	14	15	16
1960-61	26,425	7,646	2,899		7,085			8,796	22,139
1965-66	37,491	5,144	2,576	9,977	407		2	19,385	34,928
1969-70	50,800	16,764	821	16,411	809	57	15	15,924	60,990
1970-71	55,304	25,055	1,337	20,710	933	78	26	7,165	68,867
1971-72	62,560	21,486	496	28,134	1,293	89	54	11,009	106,367
1972-73	45,322	5,383	1,679	27,857	1,730	112	45	8,517	119,849
1973-74	91,904	14,047	1,939	60,970	1,566	134	280	12,968	144,778
1974-75	186,182	53,636	519	61,145	1,753	147	90	68,891	161,389
July, 1974	121,613	5,560	1,294	60,603	1,948	158	62	51,989	139,997
Feb. 1975	133,081	11,737	259	57,011	1,576	141	110	62,247	178,246
Mar. 1975	186,182	53,636	519	61,145	1,753	147	90	68,891	161.389
Apr. 1975	137,874	11,574	1,078	50,478	1,979	148	55	72,562	180,428
May, 1975	140,370	8,821	692	50,351	1,519	146	83	78,759	186,025
June, 1975	142,656	7,348	793	47,765	2,628	147	114	83,861	193,991
July 25, 1975	171,035	5,686	914	59,007	1,698	158	61	103,522	182,097

[2] Including (*i*) Paid-up Capital of Rs 5 crores,
(*ii*) Reserve Fund of Rs 150 crores,
(*iii*) National Agricultural Credit (Long-term Operations) Fund of Rs 334 crores,
(*iv*) National Agricultural Credit (Stabilisation) Fund of Rs 140 crores and
(*v*) National Industrial Credit (Long-term Operations) Fund of Rs 390 crores.

Reserve Bank of India (*Contd.*)
Banking Department

(In lakhs of rupees)

	Assets										
			Loans and Advances					Bills purchased and Discounted			
Total liabilities or assets	*Notes and coins*	*Balances held abroad*[3]	*Central Govt.*	*State Govts.*[4]	*Scheduled commercial banks*	*State cooperative banks*	*Others*[5]	*Internal*	*Government Treasury Bills*	*Investments*	*Other assets*
17	18	19	20	21	22	23	24	25	26	27	28
48,564	794	1,324		3,902		18,550			3,917	18,095	1,982
72,419	2,493	1,487	—	21,121	7,352	16,585	520		5,301	13,225	4,334
111,790	2,351	13,514		21,198	23,802	27,551	878		6,192	11,887	4,417
124,171	967	7,701	—	24,951	36,837	30,649	3,393	671	3,138	11,315	4,550
168,927	1,826	18,217	—	62,520	20,745	32,326	8,823	4,180	6,936	8,732	4,622
165,171	1,884	20,437	—	13,468	13,845	32,217	13,047	3,540	9,692	51,396	5,646
236,682	3,321	38,814	—	23,756	40,852	31,736	19,688	25,679	14,175	29,417	9,246
347,570	4,203	51,115	—	26,032	47,272	44,101	35,937	18,347	65,517	38,240	16,807
261,610	4,884	52,367	—	18,779	24,690	23,684	27,212	24,366	27,538	46,379	11,712
311,327	3,658	43,992	—	26,876	18,739	44,550	34,199	17,112	45,939	56,576	19,686
347,570	4,203	51,115	—	26,032	47,272	44,101	35,937	18,347	65,517	38,240	16,807
318,302	3,674	51,099	—	42,225	24,638	38,633	37,292	16,732	50,311	36,052	17,645
326,395	2,619	45,361	—	46,284	31,058	37,228	37,152	13,813	20,887	64 289	27,705
336,647	1,694	42,903	—	43,307	27,398	35,881	38,460	13,211	29,072	68,443	36,279
353,132	4,572	42,358	—	21,443	4,837	35,490	40,597	9,866	40,429	116,885	36,655

[3] Includes Cash, Short-term Securities and Fixed Deposits from June 28, 1968.
[4] Including temporary overdrafts to State Governments.
[5] Includes loans and advances to

(*i*) Industrial Development Bank of India from the National Industrial Credit (Long-term Operations) Fund with effect from the week ended January 1, 1965 and

(*ii*) Agricultural Refinance Corporation from the National Agricultural Credit, (Long-term Operations) Fund with effect from the week ended March 10, 1972.

Source : *Reserve Bank of India Bulletin*, July 1975.

APPENDIX B. Accounts and Other Matters

During the accounting year ended June 30, 1975, the Reserve Bank's income after making adjustment for various provisions, amounted to Rs 448.01 crores as compared with the last year's income of Rs 310.48 crores. The details of the income from various sources are as follows:

(Amounts in crores of rupees)

Items	*Year*	
	1974-75	*1973-74*
(i) Interest on Ways and Means Advances to State Governments	13.01	5.85
(ii) Interest on Loans and advances to the State Governments (other than on Ways and Means Advances referred to at item (i) above) and Commercial and Cooperative Banks	65.54	34.88
(iii) Interest on Rupee Securities and Discount on Rupee Treasury Bills	290.35	229.70
(iv) Interest and Discount on Foreign Securities, Investments and Treasury Bills	59.81	42.11
(v) Commission and profit or gain by exchange	4.13	6.65
(vi) Other income	18.98	8.83
	451.82	*328.02*
Less: Interest paid to the Scheduled banks on the additional average daily balances maintained by them with the Reserve Bank	3.81	17.54
	448.01	310.48
Less: Transfers to Funds	220.00	115.00
	228.01	195.48

Source: *Annual Report and Trend and Progress of Banking in India, 1974-75*, Reserve Bank of India.

APPENDIX C. Trends in Money Supply and Monetary Resources (Annual)

(Amounts in crores of rupees)

	Outstanding at the end of June				*Variations*
	1973	*1974*	*1974*	*1973-74*	
	1	2	3	4	5
A. Monetary Supply with the Public (1+2)	9,962	11,450	12,175	+1,488 (+14.9)	+725 (+6.3)
1. Currency with the Public	5,829	6,603	6,762	+774 (+13.3)	+159 (+2.4)
2. Demand Deposit	4,133	4,847	5,413	+714 (+17.3)	+566 (+11.7)
B. Factors affecting Money Supply Variations (1+2+3+4−5)					
1. Net Bank Credit to Government (a+b)	8,416	9 102	10,491	+686	+1,389
(a) Reserve Banks Net Credit to Government	6,149	6,570	7,515	+421	+945
(b) Other Banks' Credit to Govt.	2,268	2,532	2,976	+264	+444
2. Bank Credit to Commercial Sector (a+b)*	7.580	10,014	11,242	+2,134	+1,228
(a) Reserve Bank's Credit to Commercial Sector	290	652	625	+ 362	− 27

Appendix C.—(*Contd.*)

	1	2	3	4	5
(b) Other Bank's Credit to Commercial Sector	7,590	9,362	10,617	+1,772	+1,255
3. Net Foreign Exchange Assets of the Banking Sector	601	683	310	+71	−362
4. Government's Net Currency Liabilities to Public	482	521	543	+39	+22
5. Non-Monetary Liabilities of Banking Sector (a+b+c)	7,409	8,870	10,411	+1,450	+1,552
(a) Time Deposits with Banks	5,491	6,459	7,566	+968	+1,107
(b) Net Non-Monetary Liabilities of RBI	1,143	1,474	1,955	+331	+481
(c) Residual	783	926	890	+143	−36
C. Aggregate Monetary Resources [A+B5(a)]	15,455	17,909	19,741	+2,454	+1,832

* Includes advances made to Public Sector enterprises and State Governments for commercial purposes.

Source: *Annual Report and Trend and Progress of Banking in India, 1974-75*, Reserve Bank of India.

APPENDIX D. Monetary Resources

Year (July-June)	*Currency*	*Key Indicators*					*Key Ratios*	
		Bank Money[1]	*Money Supply*	*Time Deposits*	*Aggregate Monetary Resources*	*Reserve Money*	*Currency to Money Supply*	*Currency to Monetary Resources*
Outstanding as on last Friday (Rs crores)							Average Ratios (Per cent)	
1971-72	4,979	3,544	8,523	4,476	12,999	5,604	58.4	38.3
1972-73	5,829	4,133	9,962	5,491	15,454	6,743	58.5	37.7
1973-74	6,603	4,847	11,450	6,459	17,909	7,575	57.7	36.9
1974-75[2]	6,762	5,413	12,175	7,566	19,741	7,656	55.5	34.3
Increase over previous year (Rs crores)							Marginal Ratios (Per cent)	
1971-72	388	673	1,061	816	1,877	570	36.6	20.7
1972-73	850	589	1,439	1,015	2,454	1,139	59.1	34.6
1973-74	774	714	1,488	968	2,454	841	52.0	31.5
1974-75[2]	159	566	725	1,107	1,832	72	21.9	8.7
Percentage variation over the year								
1971-72	8.5	23.4	14.2	22.3	16.9	11.3		
1972-73	17.1	16.6	16.9	22.7	18.9	20.3		
1973-74	13.3	17.3	14.9	17.6	15.9	12.5		
1974-75[2]	2.4	11.7	6.3	17.7	10.2	0.9		

[1] Including other deposits with RBI. [2] Provisional.

Source: *Annual Report and Trend and Progress of Banking in India, 1974-75*, Reserve Bank of India.

APPENDIX E. Number of Offices of Commercial Banks in India

As at the end of year/quarter	*Scheduled commercial banks*		*Nonscheduled commercial banks*		*All commercial banks*	
	No. of banks	*No. of offices*	*No. of banks*	*No. of offices*	*No. of banks*	*No. of offices*
	1	2	3	4	5	6
1960-61	89	4,166	256	827	345	4,993
1965-66	76	6,041	33	234	109	6,275
1969-70	73	9,167	13	185	86	9,352
1970-71	73	11,393	12	148	85	11,541
1971-72	74	13,208	9	101	83	13,309
1972-73	74	14,912	9	112	83	15,024
1973-74	74	16,581	9	119	83	16,700
1974-75	74	18,250	9	133	83	18,383
Quarter ended						
June 1974	73	16,814	9	122	82	16,936
Sep. 1974	74	17,209	9	124	83	17,333
Dec. 1974	74	18,050	9	130	83	18,180
Mar., 1975	74	18,250	9	133	83	18,383
June 1975	74	18,593	9	137	83	18,730

Source: *Reserve Bank of India Bulletin*, July 1975.

Postscript

A major departure in the announcement of the credit policy for the 1975–76 busy season was the replacement of the *net liquidity ratio (NLR)* system, which was the main plank around which were tied the refinance facilities of the Reserve Bank of India since September 1964 (see p. 49). Before the introduction of the new concept of NLR in September 1964, refinance was made available to eligible scheduled commercial banks through a system called the *quota-cum-slab* system (see p. 42). With a view to regulating both the cost and availability of Reserve Bank refinance more effectively in the present situation, the operation of the refinance facilities on the basis of the *net liquidity ratio* system has been replaced by the following arrangements.

i) To ensure that banks' recourse to the Reserve Bank is kept to the minimum both in terms of amount and duration of utilisation, *refinance/rediscount facilities were made even more discretionary than in the past.* Bank will be entitled to a basic refinance limit equal to one per cent of demand and time liabilities as on the last Friday of September 1975, @ 10 per cent interest. This line of accommodation is for meeting banks' unforeseen day-to-day clearing and other operational needs.

ii) The refinance formula in regard to financing public food procurement operations will be readjusted as under:

a) an amount equal to 50 per cent of the increase in outstanding public food procurement credit between Rs 450 crores and Rs 600 crores, which will give the banks a refinance entitlement of Rs 75 crores; and

b) full refinance in respect of increase in public food procurement credit over an outstanding level of Rs 600 crores with a ceiling of Rs 900 crores. Such refinance for food procurement operations will continue to be made available at 10 per cent and banks are required to charge a rate of interest not exceeding 12 per cent on their advances for this purpose.

iii) All other refinance accommodation will be strictly at the discretion of the Reserve Bank after taking into account banks' general compliance with policy objectives, their credit deposit ratio, sectoral priorities in deployment of credit and any special considerations that may be relevant in individual cases. The rate of interest on such accommodation will range from 11.5 to 18 per cent.

iv) A part of the discretionary accommodation will be directly related to the performance of individual banks in the field of export credit.

v) Special discretionary assistance provided in the past in favour of financing petroleum companies and public sector undertakings has been discontinued, save under special circumstances, such as the need for forming consortium arrangements amongst banks to finance large borrowers.

vi) A basic bill rediscount limit equal to 10 per cent of total gross bills purchased and discounted with banks as on last Friday of September 1975 including those rediscounted by the Reserve Bank of India has been made available at the Bank Rate. Additional bill rediscount limits will be granted only at the discretion of the Reserve Bank after discussions with banks, at rates ranging between 10 and 15 per cent.

The operation of refinance facilities on the basis of the NLR was thus discontinued. The basic anti-inflationary stance of credit policy remained unchanged for the 1975–76 busy season. The approach to credit policy was motivated by the main objective of facilitating sustained growth and stimulating investment, without impairing the basic apparatus of monetary restraint. Stated differently, the credit policy aimed at imparting some measure of flexibility in the credit discipline without endangering price stability. The financing by commercial banks of food procurement on an enormously larger scale, selective liberalisation of margin requirements (in view of the anticipated enlargement of supplies in the agricultural commodities) and of inventory norms and prescription of a ceiling on lending rates bear ample testimony to the flexibility of credit policy, without impairing the fundamental objective of preventing a recrudescence of inflationary pressures.

In August 1976, the Reserve Bank of India has raised the statutory cash reserve ratio as per section 42(1) of the R. B. I. Act, 1934, from 4 per cent to 5 per cent* with a view to arresting the further rise in prices. It is estimated that a sum of rupees about 150 crores extra per annum will be impounded in cash from the deposits of the banking system by the adoption of this measure and that further inflationary pressures will be checked. The Reserve Bank has however decided to grant interest at the rate of 5.5 per cent per annum on excess one per cent deposit.

Another important feature is the basic change in the concept of seasonal pattern of banking. This change is reflected in the increased advances of banks in industries. The seasonal character has also become less significant with the development of new industries which are not crop-based. Seasonal variation moderates as nonagricultural sector expands. The attenuation of seasonal variation is the reflection of the growth of nonagro based industries which absorbed a large part of increase of bank credit (pp. 65–68). The traditional concept of busy-season and slack-season based on the seasonal pattern of a purely agricultural economy has been given a decent burial with the changing needs of the semi-industrial economy. Instead of half yearly announcement of credit policy twice a year, the Governor of the Reserve Bank of India has rightly

* Cash reserve ratio has been further pushed up to 6 per cent with effect from November 13, 1976, in order to overcome inflationary pressures that have broken out again.

announced to make a quarterly review of the credit policy according to the stringency and superfluity of the money market conditions.

Sources: i) *Reserve Bank of India Bulletin*, September 1975.
ii) *Annual Report and Trend and Progress of Banking*, 1975–76 (Supplement to *Reserve Bank of India Bulletin*, July 1976).

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